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Participatory Finance in Sudanese Banking System: Perceptions on Performance, Obstacles and Prospects

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By
Gaffar Abdalla Ahmed

**A thesis submitted to the University of Durham for the
Degree of Doctor of Philosophy
Durham University
School of Economics, Finance and Business
England**

07 JUN 2007

March 2007



Declaration

I hereby declare that the work reflected in this thesis and submitted for the degree of Philosophy Doctor of the University of Durham, has not been already accepted in substance for any degree and not concurrently submitted in candidature for any degree. I further declare that this thesis is solely based on my own research. The author is responsible for the entirety of this thesis.

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Gaffar Abdalla Ahmed

Abstract

Islamic finance has gained important momentum in the 1990s, and is now recognised by financial institutions and regulators all over the world. The development of Islamic finance in the Sudan has been through the Islamisation of economic and financial sectors along with the political shift towards Islam. It is, therefore, important to assess the progress and performance of Islamic financial instruments in a political setting such as in the Sudan.

The study, therefore, covers, explores and evaluates the development of Islamic banking in the Sudan for the period 1990-2005 mainly, by focusing on five main areas: first, it investigates whether the PLS contracts are dominating the Islamic banking system in Sudan. Second, the study evaluates *musharakah* characteristics and its performance perceptions. Also, the study analyses how staff characteristics, bank characteristics and overall environment affect the preferences and performance of *musharakah* finance. Third, it investigates the factors influencing decision making in Islamic banks as regard to *musharakah* finance. Fourth, it investigates the implications of using *musharakah* mode of finance. In this regard, this study examines the perception of the implications of using the *musharakah* mode of finance by the Sudanese Islamic banks and provides an empirical assessment of these perceptions about *musharakah* characteristics, performance, preference and obstacles. This study also provides an empirical investigation of how central bank policies have affected *musharakah* finance in Sudan. Fifth, it investigates *musharakah* management to recognise the obstacles and factors influencing decision making and aims to suggest possible remedies. In fulfilling its aim and objectives, this study utilised both primary and secondary data from Sudan.

This study finds that banking staff prefer *musharakah* over other types of Islamic modes of finance. However, in reality the Sudanese banks prefer *murabahah* over other types of Islamic modes of finance with a gradual shift towards *musharakah*. It is therefore argued that government pressure has been the major factor behind this shift towards more *musharakah* finance. The study also shows that significantly, the dominant type of *musharakah* is a short term one which lasts for 3 to 6 months. The results indicate the correlation between *musharakah* risk and the average age of *musharakah*. Hence, the major dilemmas facing the present Sudanese Islamic banks nowadays are the fact that these banks have to involve in long term finance according to its theory.

The non-parametric test confirms that the perception about the performance for *musharakah* is high in both profitability and risk. However, the comparative financial performance of the Islamic financial methods found no difference in both risk and profitability. The credit policy and size of banks was found to be the most important factor influencing the distribution of bank funds among different types of finance. Lack of proper feasibility studies was found to be the main cause of non-performing *musharakah* finance. The lack of PLS modes of finance performance, because of managerial efficiency, can be considerable and may threaten the existence of Islamic banking, which is already facing strong competition. Significantly, lack of specialized departments were found to be the main cause of the weakness in the following up. The study finds that financial capability is the most important factor determining the capability of the entrepreneurs. Satisfaction with performance measurement systems was not high and not acceptable. Training provided to the employees is not enough and needs strengthening.

There is a need for national policies specially designed and oriented towards SMEs as well as a policy to ending the current BOS financing policies hindering *musharakah* and BOS discriminatory regulations so as to encourage PLS finance.

Based on the results, this study made a number of recommendations to manage and measure *musharakah* risk.

Dedication

In the name of Allah, the Most Beneficent, the Most Gracious, the Most Merciful. Praise is to Allah the Lord of creation, prayers and peace to His most honourable Prophet Mohammed (PBUH), relatives of Prophet Mohammed and his Companions and followers.

This is dedicated with love to my family whose sacrifices shall not go in vain: to my mother, father and brothers, without their support this thesis would not have been possible. It is also dedicated to those who are struggling hard for their future and to others who are hardly seeking the way out.

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As I look back on the work that eventually resulted in this research, I realize that a number of individuals and institutions provided me with indispensable assistance and guidance. The list of contributors is almost endless; it would be impossible to mention all of them by name but I would especially wish to thank the following for their effort in assembling this research.

With a feeling of humility I must appreciate the comments and guidance I used to receive from my supervisor Professor Rodney Wilson. I would like to express our profound to Professor Rob Dixon. I am also deeply grateful to the School of Economics, Finance and Business, School of Government and International Affairs, and Durham University.

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My heart felt gratitude to my loving family.

Last but no means least, my highest gratitude goes to Sudan, my native least, and to U.K.

Relevant Quote

The Prophet (peace be on him) stated in a *hadith qudosi* that Allah, the Great and Glorious says, “I make a third with two partners as long as one of them does not cheat the other, but when he cheats him I depart from them.” (Reported by Abu Daoud and by al-Hakim, who calls it sound) Traditions (*sunnan*) of Abu Dawood, Book of Sales, No. 2936.

The only true wisdom is in knowing you know nothing. (Socrates)

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1.1 An Overview of the Research Background

1.1.1 Islamic Banking and Finance

Islamic banking is the fastest growing sector in the banking system; its market share of assets has risen from 2% in the late 1970s to 15% up to the mid-1990s. Moreover, capital, assets and deposits have grown by a rate between 15-20% during the last three decades (Ibrahim, 2006). If this trend continues, it is anticipated that Islamic banks would share between 40-50% of the Islamic world's savings within the next twenty years. Hence, no doubt, the phenomenon of Islamic banking represents a fascinating development in the history of international finance, as Islamic banks have not only managed to survive and grow under the pressures of today's global market, but at the same time, they are being governed by religious principles. Nevertheless, the question as to whether Islamic banking will make the much expected contribution to investment and growth, poses a challenge for bankers, researchers, and policymakers alike.

Islamic banking, however, still remains mysterious to many people, including academics. Therefore, countless articles and books on Islamic banking and finance describe the nomenclature and ideologies behind it. Many researchers Such as Kahane (1977), Mirakhor (1986) Iqbal *et al.* (1998), Bashir (1999), Samad (1999), Dar and Presley (2000) and Al-Jarhi (2003) described the theory and an overall performance and challenge to some experience in some countries and cross-country as well. Nevertheless, to date there has been limited empirical research analyzing the techniques in detail. A lack of data has been a major challenge and reason behind this, especially in Sudan where the experience of Islamic banking started in the late seventies of the previous century.



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It is well known from the literature on Islamic economics that the raising and mobilising of financial resources in an Islamic economy must be guided by interest-free instruments. Accordingly, banks may perform all their functions provided that they avoid the payment and receipt of interest. This practice already exists and is being constantly refined and modified to meet the rapidly changing needs of ever more sophisticated businesses.

There are seven basic Islamic financing contracts. The underlying concepts for each method are simple and can be compared to existing western financial instruments. However, actual financing deals can become very complicated, as some banks modify the structure to suit the requirements of specific investors. These deals may contain elements of more than one of the basic Islamic contracts. These methods affect both assets and liabilities on a bank's balance sheet and can be divided into two groups: the ones that are based on the PLS principal (core modes) and the ones that are not (marginal)¹.

Almost all theoretical models of Islamic banking are based on Profit and Loss Sharing (PLS) contracts, whether *mudarabah* or *musharakah* or both². By such financial instruments, both the supplier of the capital and the entrepreneur share in the risks. Consequently, both prosper when returns are favourable and suffer

¹ These seven contracts are *mudarabah*, *musharakah* as PLS Methods. *Murabahah* (cost plus financing), *ijarah* (leasing) & *Ijarah wa-'iqtina* (financial lease), *qard-hasan* (beneficence loans), *bai muajjal* (deferred payment sale) and *salam* (purchase with deferred delivery) as Non PLS Methods. Compared with non PLS mode of finance, PLS modes are more risky, PLS can not systematically be made dependent on collateral or other guarantees, administration of PLS modes is more complex compared with non PLS, these activities include the determination of profit and loss sharing ratios on investment projects in various sectors of the economy, and the ongoing auditing of financed projects to ensure that Islamic banks' share are fairly calculated. Therefore, Islamic banks, in order to safe guard funds and realize profits, would need to rely on a set of appropriate policies and adequate infrastructure for portfolio diversification, monitoring and control in PLS modes than non-PLS modes.

² *Mudarabah* is a trust based financing agreement whereby an investor (Islamic bank) entrusts capital to an agent (*mudarib*) for a project. Profits are based on a pre-arranged and agreed ratio. A *mudarabah* agreement is a kin to western style limited partnership, with one party contributing capital while the other runs the business, and profit is distributed based on negotiated percentage of ownership. In case of loss the bank earns no return or negative return on its investment and the agent receives no compensation for his/ her effort ZAHER, T. S. & HASSAN, M. K. (2001) A comparative literature survey of Islamic finance and banking. *Financial Market, Institution and Instruments*, Vol. 10, 155 - 199. *Musharakah* or *shirkah* can be defined as a form of partnership where two or more persons combine either their capital or labour together, to share the profits, enjoying similar rights and liabilities SAEED, A. (1999) *Islamic Banking and Interest: A study of Prohibition of Riba and its Contemporary Interpretation*, New York, Brill Academic Publishers.

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together when returns are poor (Dar and Presley, 2000). This is the basis for what became known as “interest-free Islamic banks”. In addition to PLS contracts, there are non-PLS contracts such as *salam* and *murabahah*³.

Without a doubt, the aforementioned contracts are generally accepted amongst most Islamic scholars as long as both parties in the business adhere to the conditions of each contract.

These methods of finance are considered economic choices; therefore there are a number of economic choices for both the Islamic bank and the customer when making business contracts between them (Ahmed, 2005). Then, it is possible to conclude that the range of contracts available to customers is widened. This is an example of the efficiency-enhancing characteristics of spectrum filling (Iqbal, 2002). The assumption is made that both parties will be rational in order to choose a contract that will favour both the bank and the customer. A customer's decision to invest according to which method is used, or whether to continue to invest with a particular Islamic bank would mainly depend on the risk of the method and the projects in which their funds are invested, the returns which they expect to receive from those projects using this method, compared with returns from other similar risk class projects, and the bank's ability to achieve those returns (Pastor, 1999). Other factors include the time in which they can return the capital, and whether they have the ability, which the project demands, such as the managerial efficiency and so forth (Ahmed, 2005). Generally speaking, the profitability and risk factors are the ones that play a dominant role, as both parties are fundamentally geared towards maximising their profit and minimising their losses (Ahmed, 2006). Just as one cannot deny that the other factors

³ *Murabahah* is generally defined as the sale of a commodity for the price at which the vendor has purchased it, with the addition of a stated profit known to both the vendor and the purchaser. It is a cost-plus-profit contract. Islamic financial institutions aim to make use of *murabahah* in circumstances where they will purchase raw materials, goods or equipment etc. and sell them to a client at cost, plus a negotiated profit margin to be paid normally by instalments. With *murabahah*, Islamic financial institutions are no longer to share profits or losses, but instead assume the capacity of a classic financial intermediary. *Bai Salam* (Purchase with Deferred Delivery) is a contract in which the buyer pays the seller the full negotiated price of a specific product which the seller promises to deliver at a specified future date. This transaction is limited to products whose quality and quantity can be fully specified at the time the contract is made SALEH, N. A. (1986) *Unlawful Gain and Legitimate Profit in Islamic Law*, Cambridge University Press, Cambridge.

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sometimes play a greater role, he can also not negate the fact that these other factors, directly or indirectly, affect the profitability and risk margins.

The existing research in Islamic banking and finance has focused primarily on the conceptual issues underlying interest free banking including the viability of Islamic banks and their ability to mobilise saving, pool risks and facilitate transactions (Karsten, 1982). On the other hand, few studies had focussed on the policy makers of a financial system without interest payments (Khan and Mirakhor, 1987). What is noteworthy is that empirical work on the performance evaluation of *musharakah* financed by Islamic banks is sparse. The lack of complete data impeded any comprehensive analysis of the experience of the last three decades. Whatever empirical work has been done so far has yielded inconclusive results (Bashir, 1999).

Iqbal *et al.* (1998) distinguish two models of Islamic banks based on the structure of the assets. The first is the two-tier *mudarabah* model that replaces interest by profit-sharing (PS) modes on both liability and asset sides of the bank. In particular, in this model all assets are financed by PS modes of financing (*mudarabah*). This model of Islamic banking will also take up the role of an investment intermediary, rather than being a commercial bank only (Chapra, 1985). The second model of Islamic banking is the one-tier *mudarabah* with multiple investment tools. This model evolved because Islamic banks faced practical and operational problems in using profit-sharing modes of financing on the asset side. As a result, they opted for fixed-income modes of financing. As mentioned earlier, fixed-income instruments include *murabahah*, *istisna'*, *salam* and *ijarah*.

If one of the main characteristics of Islamic finance is the PLS nature of its financing modes, risk-sharing, as a result, is another important aspect of it. In line with this, the model by Diamond and Dybvig (1983) shows the superiority of risk-sharing provided by the bank. By offering liquid deposits to savers and choosing an appropriate mixture of liquid and illiquid investments, banks provide complete insurance to savers against liquidity risk, while simultaneously facilitating long-run investments in high-return projects. Therefore, savers or

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shareholders can liquidate their asset while firms' capitals are sustained and not jeopardized. Nevertheless, Kahane (1977) believes that capital requirement cannot deter the bank risk and may even intensify the problem.

To mention a few of the differences between Islamic finance principles and conventional banking the researcher might say Islamic finance does not deny that capital, as a factor of production, deserves to be rewarded. Islamic finance, on the contrary, allows the owners of capital a share in a surplus which is uncertain (Ariff, 1988). Hence, one of the main selling points of Islamic banking, at least in theory, is that, unlike conventional banking, it is concerned about the viability of the project and the profitability of the operation but not the size of the collateral. Good projects which might be turned down by conventional banks for lack of collateral would be financed by Islamic banks on a profit and loss sharing (PLS) basis. It is especially in this sense that Islamic banks can play a catalytic role in stimulating economic development. In many developing countries, of course, development banks are supposed to perform this function. Islamic banks are expected to be more enterprising than their conventional counterparts. In practice, however, Islamic banks have been concentrating on short-term trade finance which is the least risky.

Early Arabic literature on the Islamic banking has mostly discussed how a financial institution could work without interest adopting the contracts mentioned in Islamic *fiqh* like *mudarabah*, *shirkah*, etc. It did not address itself to the larger question of how the entire financial system of a country could be organized free of interest and work according to *shari'ah*. It does not mention central banking and does not discuss the relationship between the individual Islamic banks and the central bank of the country. This is quite understandable in view of the political realities and the actual possibilities in the Arab world at that time (Siddiqi, 1992).

1.1.2 Profit and Loss Sharing (PLS)

The three key features of interest-free banking practices are the absence of the rate of interest in bank transactions, the presence of risk in bank operations and

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the strict adherence of bank operations to the tenets of the *Shari'ah*. Among these, the second issue, namely, the risk-taking feature, has posed the greatest challenge to the interest-free banking practitioners. Indeed, using PLS modes in Islamic banks changes the nature of risks these institutions face. The returns on saving and investment deposit are state contingent. As the depositors are rewarded on a profit sharing method, they share the business risks of the banking operations of the bank. The profit and loss sharing feature of these depositors introduces some other risks. Furthermore, the use of Islamic modes of financing on the asset sides changes the nature of traditional risks.

Hence, profit and loss sharing has recently captured the attention of academicians, bankers and policy makers, particularly those in the Middle East. These contracts are characterized by risk sharing, an element that forces the contracting parties especially the financier to fund only sound projects. The theoretical analysis of both the profit sharing (*mudarabah*) and profit and loss sharing (*musharakah*) have received a major boost from a variety of models, including Khan (1986) and Haque and Mirakhor (1986) and empirical support among others for example, from Bashir and Darrat (1992). The bold claim of these models is that if the interest payment on financial capital were to be replaced by the profit sharing arrangement, the level of investment would be enhanced instead of weakened.

Since the entrepreneur is interested in convincing the investor to provide the required amount of capital to activate the project, he or she has to gain the investor's financial support through information transfer. One way to do this is for the entrepreneur to show his or her own willingness to invest in the project. Such willingness may serve as a signal to the financial market about the project's quality. However, the contract should be structured in such a way that the entrepreneur has no incentive to cheat.

Bashir and Darrat (1992) have proved that the possible effects of internal equity and profit and loss sharing ratio in the equity participation contract on the level of investment are negative. While the underlying theory expects the effects of internal equity to be positive, Haque and Mirakhor (1986) assert that an equity

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contract is superior to debt contract because the enterprise can improve profit due to the absence of some limitations normally imposed by debt. They also point out that the level of investment will increase in an economy as a result of banking with equity participation.

Weitzman (1985) has shown that equity participation can in effect increase the potential for profits along with the benefits of decentralized decision making. Their arguments, however, are predicated on the premise of absence of moral hazard as suggested by Khan (1986) and risk overestimation by the bank.

Banks, however, resolve the asset substitution moral hazard and adverse selection problem through monitoring and feasibility studies⁴. Banking theory would indicate that banks would be relatively more exposed to adverse selection during economic upturns and to moral hazard during downturns (Dewenter et al., 1998).

Obviously, adverse selection can be avoided by careful screening of finance applicants. When a bank provides equity and debt finance simultaneously, it will have more access to information than when only debt finance is provided. The researcher can, therefore, conclude that screening would be more effective and adverse selection less probable with universal banking. Reducing possibilities of moral hazard requires monitoring the firm that obtains finance. All three kinds of ex ante, interim and ex post monitoring must be exercised to be effective (Aoki,

⁴ Adverse selection is the problem created by asymmetric information before the transaction occurs. For an Islamic banker it occurs when the potential applicants for financial assistance who are the most likely to produce an undesirable outcome are the ones who most actively seek out a contract, and are thus most likely to be selected. Since adverse selection makes it more likely that banks' offers might be made to bad credit risks, suppliers may decide not to make any or few offers even though there are good credit risks in the market. Moral hazard is the problem created by asymmetric information after the transaction occurs. Moral hazard, on the other hand, occurs when the bank is subject to the hazard that its partner has the incentive to engage in activities that are undesirable i.e., against the contract. Since moral hazard lowers the probability that the offer will be repaid, the banks may decide that they would rather make limited deals or no deal at all SADR, K. (1999) The role of *musharakah* financing in the agricultural bank of Iran. *Arab Law Quarterly*, 14, 245 - 256. Hence, a bank can be exposed to moral hazard when the firm obtaining finance uses the funds for purposes other than those for which finance was advanced. This could lead to business failure and inability to repay on part of the debtor firm. The bank would be exposed to adverse selection when it fails to choose the finance applicants who are most likely to perform AL-JARHI, M. A. (2003) *Islamic finance: an efficient & equitable option*, Jeddah, The Islamic Research and Training Institute.

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1994). Theoretically, equity finance provides the bank with access to information necessary to practice monitoring at all intervals. It also reduces the firm's incentives to substitute riskier for safer assets. Furthermore, when the firm faces problems, the bank, as an equity holder, will assist in order to protect its investment (Al-Jarhi, 2003). Meanwhile, debt finance would reduce the firm's incentives to hide its profits.

Islamic banks would presumably be willing to bear greater risks only if they were compensated by high enough returns. Nevertheless, Islamic banks might accept investments with greater variability in the expected rate of return because part of the increased risk would be borne by the depositors (Karsten, 1982).

It is easy to say that the moral hazard problem relates mainly to situations which are dominated by non-incorporated small scale firms. The theory has little relevance to the modern large-scale corporate sector which accounts for the bulk of investment activity. The owner of a small one man firm is able to capitalize on relative informational advantage by under reporting the true return of investment to his financier. But this can not be contemplated when the firm is a legal person, as it will simply mean that the company's board of directors may under report the true returns to the shareholders (Tag el-Din, 1991).

Indeed opponents of the Islamic financial system argue that the introduction of a financial system based entirely on Islamic profit and loss sharing (PLS) arrangements would reduce savings and retard development due to increased uncertainty of the rate of return and consequently high risk surrounding consumption and savings decisions. This is thought to adversely influence the willingness to save under an Islamic financial framework (Karsten, 1982).

Al-Swailim (2000) argues that the Islamic banks, so as to have optimal intermediation, have to base their finance on a bank's agency relationship (e.g. *wakalah*, *mudarabah*, *musharakah*) with both sides: savers and businessmen. In theory, such a model of banking achieves an optimal level of efficiency and profitability. The common model of existing Islamic banks (based on *murabahah* on the asset side) on the other hand, is less efficient than the proposed model.

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Providing finance on a PLS basis requires constant vigilance by the banks over the utilization of funds. This can provide benefits in the form of improved financial control. Banks are still likely to have to increase their staffs by employing engineering and management experts to evaluate projects more thoroughly. This results in increased costs that bankers will have to balance against prospective increases in rates of return that could be earned by making more efficient use of funds (Karsten, 1982).

Critics of Islamic banking argue that moral hazard incidences arise more often in equity contracts than in debt contracts. If a contract could be structured so that moral hazard would only occur in certain situations, then there would be a reduced need to monitor partner firms, and the contract would be more attractive than the equity contract. The debt contract has exactly these attributes, because it is a contractual agreement by the borrower to pay the lender fixed amounts periodically (Sadr, 1999). Furthermore, the critics admit that by better monitoring and closer supervision, they can make up for the shortage of information to overcome the moral hazard and adverse selection problems (Sadr, 1999).

The elimination of interest and its replacement by profit-loss-sharing would not only change the level of uncertainty but also redistribute the consequences of uncertainty over all parties to a business (Al-Harran, 1993). It would moreover, by removing the daily destabilising influence of fluctuating interest rates, bring about a commitment of funds for a longer period and also introduce a discipline in investment decisions.

Islamic banks, thus, have a lower degree of control over the management of the enterprise they finance through the PLS contract. By contrast, credit risks related to financing through non-PLS modes are lessened by the possibility of collateralization, including mortgaging. The assessment of an appropriate level of the capital adequacy ratio for Islamic banks should be primarily based on systematic analysis of the underlining asset portfolio between PLS and non-PLS transactions (Errico and Farahbaksh, 1998). Although the PLS contracts perhaps present significant risks to Islamic banks, it also presents profitable opportunity.

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Accordingly, the assessment and management of investment risk becomes more difficult in an Islamic environment than in conventional banking because of the following factors (Errico and Farahbaksh, 1998).

On the other hand, the depositor's preferences for using an Islamic bank may be due to religious or ethical reasons, while the investors of these banks do not necessarily have this motive (Ismail, 2006). Nevertheless, financing under *musharakah*, the capital owner has a right to enter into the management and hence, have some control over the problems created by the informational asymmetry and moral hazards.

Dar and Presley (2000) argued that under PLS, Islamic banks do not have any controlling rights, but they share financial risks with the borrowers. They called for reforms in banking regulations to balance the management and control rights between Islamic banks and managers of the companies they invest in. In this way shareholders are not just passive capitalists but share decision making in the running of the organization. Choudhury (2001) also argued for the use of *musharakah* to realize the extensively relational perspectives of Islamic socio-economic co-operation with extensive participation across agents, firms and sectors, and to transform venture capital into a more integrated financial instrument. He pointed out that resource mobilization in the economy-wide case through the extension of *musharakah* from limited liability and partnership to extended form of economy-wide and inter-sectoral participation causes linkages between real and financial resources.

Some arguments, state that in the absence of Islamic ethical values functioning in the business community, engaging in risk return activities such as *musharakah* by the bank without adequate safeguards may lead to the bankruptcy of the banks (Mirakhor, 1987). This legitimate concern of the authorities translates into policies which approach the idea of risk return sharing, so essential to the adoption of Islamic banking, with highest caution, thus resulting in heavy reliance on weekly Islamic modes of finance, such as mark-up, which have minimum probability of risk. And this way leads to policy tools such as limits on the bank's rate of return, moral suasion, and credit rationing being used to steer

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the banks away from risk return sharing projects through *musharakah* (Mirakhor, 1987).

In practice, two approaches have been adopted by Muslim countries for eliminating interest from their financial systems. Three countries, Pakistan, Iran and Sudan, have opted for the removal of interest from the operations of all their financial institutions simultaneously. In contrast with this, a number of countries, including some non-Muslim ones, have allowed the establishment of Islamic banks alongside conventional interest-based banks (Chapra and Khan, 2000).

Sudanese Islamic banks' experience represents one of the rare occasions in the world in which this system has worked in practice and has been heavily supported by specific banking legislation. The experience is associated with central bank financing policies geared towards Islamisation of the entire banking system. Currently an effective banking system only operates in the north, where the financial institutions are all *Shari'ah* compliant.

Elhiraika (1998) argued that the activities of Islamic banks in Sudan are constrained by the macroeconomic environment in general and repressive monetary and credit policy in particular. He concludes that when such constraints are removed only then may the Islamic banking system make a meaningful contribution to financial and economic growth in Sudan.

Ahmed (1998) studied the effects of religion on the design of management control systems of banks by comparing Islamic banks with Islamised banks in the era before Islamisation in Sudan to see the effects religion has on management control systems. It was found that religion affected organisational objectives, strategies, banks' structure, and investment mechanisms. According to Ahmed (1998), the effects of religion on management control systems are clearly seen in the following aspects: the establishment of *Shari'ah* supervisory boards to audit the banking practice from a religious point of view, the recruitment, training and evaluation of staff according to the requirements of religion, and the great influence of religion on the rules and procedures governing investment operations. This is in addition to various control problems

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that Islamic banks have to solve such as, finding a practical definition of “profit-optimization”, the “timely liquidation of ventures” and dealing with interest-based banks in the correspondent banking business.

Elhiraika (2003) studied Islamic banking instruments for financing agriculture in Sudan, and his empirical research indicates that Islamic financial instruments might offer efficient alternatives in rural and microfinance on a profit and loss sharing basis. In addition, Hussein (2003) estimates the operational efficiency in 17 Sudanese banks between 1990 and 2000. His findings show that the average efficiency is almost stable between 1990 and 2000. However, there are wide efficiency differences across Sudanese banks. Despite the small size of the foreign banks, they are more efficient than state-owned and joint-ownership banks. He also examines the sources of inefficiency by estimating a second stage inefficiency regression.

Hussein (2003) concluded that in order to improve efficiency, Sudanese banks should first increase their (low) paid-up capital ratio, but not through merger and acquisition activities and second should implement serious programmes for human capital development in order to reduce the current level of cost inefficiency. For him Sudanese banks have an advantage in *musharakah* modes of finance, which are not fully utilised yet. The results support the moral hazard hypothesis. His findings suggest a positive relationship between risk and inefficiency. These results suggest that Sudanese banks have an advantage in managing *musharakah* and *murabahah* contracts.

In addition, Hassan (2003) believes that the amounts of *musharakah* in the Sudanese banks balance sheet reduce cost efficiency, but they do not raise profit efficiency, which confirms the hypothesis that these instruments are inherently more risky. His results show that the amount of *musharakah* over off-balance sheet items, however, impacts both cost and profit efficiency positively but the amount of *murabahah* deposits over off-balance sheet items influence only profit efficiency positively. Fee-based activities are the most important source of income for many Sudanese banks and a trade-off between *musharakah* and

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murabahah finance and fee-based financial services may have an off-setting impact on cost efficiency (Hassan, 2003).

Empirical evidence from 17 Islamic banks from 10 countries, including the Sudan, indicates that credit risk perception is highest in PLS modes in general and lowest in *murabahah* followed by *ijarah* and *istisna'*, respectively. *Salam* ranks average in terms of credit risks. In terms of operational risk (legal risk, understanding of contracts, management of contracts etc), *murabahah* and *ijarah* have the lowest risk whereas *salam* and *istisna'* have the highest risk (Khan and Ahmed, 2001).

Al-Harran (1993) identified that risk, the difficult nature of investment and long-gestation period in receiving returns and problems of management are the major reasons why Sudanese Islamic banks do not undertake equity financing modes. Indeed, PLS modes require adequate experience in management, additional supervisory and monitoring roles compared with sales-based modes which are relatively less risky and easy to manage. Moreover, PLS modes are subject to erosion of investment in the case of a loss that is why ISBs are hesitant to undertake them at the initial phases of their operations. Instead they use mostly debt-based *salam* and *murabahah* instruments which shift most of the risk to the client. By contrast, Ahmed (2005) has reported that *musharakah* in Sudan had less risk compared with other modes of finance in two Sudanese banks for the period 1993-1999 while most of the remaining sampled banks were reported to have no difference between their modes performance.

While research on *musharakah* mode of finance in Sudanese Islamic banks remained limited, this applies to other countries as well. The literature indicates that only a few studies available on the performance of *musharakah* in other countries. For example,

Dooren (1990) studied the partnership finance for the rural credit in Sudan before the Islamisation period, and he believes that the experience is still limited but worth the monitoring and can be developed to be applied elsewhere. In supporting this, Abdalla (1997) reported that the experience of the SIB still needs

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fine tuning with a respect to the minimizing of transactions, recruiting special personnel, and applying innovative collaterals. Ahmed (2003) has studied the financial performance of the Islamic finance methods in nine Sudanese banks between 1993 and 1999. His findings support the theory of high risk of the PLS in two banks only.

El-Bhasri and Adam (1997) examined the experience of the Sudanese Islamic Bank, with a view to assessing the impact of its partnership financing on enterprise development. Their findings show that the bank was able to reach new entrepreneurs who have not gained access to this unconventional finance scheme. Abdalla (1997), on the other hand, developed an institutional understanding and noted that the potential of SIB experience in *musharakah* financing of SMEs can be expanded to other banks. In the same direction Ibrahim (1999) reported that the potentiality of PLS *musharakah* finance to work in conventional western banks.

Osman (1997) found *musharakah* finance experience in Sudan is more flexible in financing working capital compared with *murabahah* and *mudarabah*. However, he suggested a mixed contract of *musharakah* and *ijarah* as a way of overcoming the asset evaluation constraint. Ahmed (2005), on the other hand, investigated the risk and profitability for the Islamic finance modes with connections to the human resources side of the development in Islamic banking and therefore reached a conclusion that the lack of knowledgeable bankers capable of selecting, evaluating and managing profitable projects is a significant cause for the paucity of PLS projects. The paper exposes the key issues involved in bad debt and general risk for the Islamic finance methods, and demonstrates the need for bankers trained in feasibility studies skills to make up for the lack of efficiency in managing, controlling and following up *musharakah* projects.

Nasr (2005) studied the pecking order of Islamic finance methods in Egypt with special reference of *musharakah*. Nasr (2005) argues that if the pecking order hypothesis holds, then, owners should be reluctant to use the *musharakah* mode of finance mainly due to the absence of a control factor from the demand side and high risk embedded in the instrument from the supply side. According to

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Nasr (2005) small business owners prefer to be financed using *murabahah* then *ijarah wa iqtinaa*, followed by *mudarabah* and lastly *musharakah*.

Ahmed (2007) evaluated the performance of Islamic entrepreneurship projects financed through the banking system in Sudan. His initial results indicate that the need of long term SMEs finance which is the major dilemmas facing the present Sudanese Islamic banks nowadays. His recommendations show the need of a fair and proper measurement should be taken to estimate the management role on the profit and this should be reflected on the management share of profit denoted to the entrepreneur.

Hamdan (1997) studied *musharakah* financing for small enterprise under the Jordan Islamic Bank's lending programme. He concluded that it is premature to judge the financial and managerial results for the SMEs finance using *musharakah*. In a similar study for Pakistan, Akhtar (1997) stated that there is a need for proper environment to introduce *musharakah* finance in Pakistan. In this context, he recommended the enactment of *musharakah* law and other regulations to close possible loopholes of cheating, fraud and concealment.

Management input in the agricultural bank of Iran plays an important role in the shift to *musharakah* financing from the alternative low risk tools. Having both, a banking background and agricultural expertise, in addition to field experience, helped the board of directors to understand the need for timely and effective solutions (Sadr 1999). Yesseri (1999) studied the Iranian experience of *musharakah*, and with lack of data, he concluded that the large scale of *musharakah* finance is only focuses on housing finance. He further added that the inflation rate remarked as a serious threat to this practice. Najmabadi (1997), on the other hand, proposed a model from the Iranian experience of *musharakah*. His model tried to avoid, or at least attenuate, many existing complications and procedural inconsistencies and ambiguities in Iran, as well as the system and operational problems. It does not, however, propose any change in the existing methods of mobilizing and attracting bank deposits, as the methods are on the whole satisfactory.

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Laffont and Matoussi (1995) developed a theory of sharecropping, from the Tunisian experience, which emphasizes the dual role of moral hazard in the provision of effort and financial constraints. Their model is compatible with a large variety of contracts as observed in Tunisia, and their findings support the lower efficiency when the tenant's share of output is lower. The roles of financial constraints in explaining which type of contracts is selected are supported by his findings.

Borhan's study (1997) focused on the doctrine and application of partnership in Islamic commercial *sharia'* law in Malaysia. He presented the opinions of different sunni schools about *musharakah* rules with especial reference to *shafi'ate* school followed by any discrepancies between *sharia'* and the Malaysian commercial law. Al-Harran (1997) has suggested *musharakah* financing for marketing as an integrated approach to grassroots development in the Malaysian fishing industry.

It is true that these studies have contributed to the development of the field; their research framework refrained from delving into complicated *musharakah* issues beyond surface. This current study, therefore, take the research in the field a step further by directly engaging with the many unresolved and micro-country based specific issues related to the practice of *musharakah* financing.

1.2 Motives, Contribution and Significance of the Study

In view of the nature of Islamic banking and finance and the lack of research on its impact and implications on banking operations and customers in Sudan, this study aims to provide an empirical investigation of how *musharakah* finance works in Sudan.

Despite the increased number of the Islamic banks and the increased studies, articles, and researches on the theory and ideology of Islamic banking, few researches deal with the actual practical experimentation of interest-free financial and banking system. Because the subject of the Islamic banking is relatively new, several puzzles and misunderstandings still exist for academics and policy

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makers alike. Whether a system that forbids the interest charges or payments can be viable in a modern economy is a question often raised by economists, western economists and even by some Muslim economists. However, what is missing is a comprehensive empirical investigation that analyses the Islamic banks' instruments and evaluates their successes and failure in the light of their conformity to Islamic principles.

The significance of this study stems from the fact that despite the apparent success of Islamic financial institutions in many corners of the world, many governments are reluctant to endorse a full scale shift towards Islamic finance. Limited knowledge about the economic effects of the profit and loss sharing methods of the Islamic finance is one of the reasons behind such reluctance. The study hopes to contribute to a better understanding among researchers and policy-makers as to the likely implications of using *musharakah* mode of Islamic finance. Further, this study aims to provide an empirical investigation of how central bank policies have affected *musharakah* finance over the period 1990-2005 in Sudan.

This study extends the existing literature on Islamic banking and finance in two directions. First, it applies methods that are scantily used to analyse implications of using PLS methods. Second, it provides empirical evidence for a country for which no research (or little research) has been conducted to understand the nature and dynamics of *musharakah* mode of finance. In the case of the Sudan there has been a dearth of studies on the impact of Islamic banking practice. However, relatively little in the way of concrete economic analysis has been undertaken. Consequently, there is a need for in-depth analysis of the effects of this practice. The study addresses this issue of the Islamic banking practice in Sudan to fill this gap in the literature. In this context, the study departs from previous studies by using different techniques of analysis, a longer period (most of the previous studies use a short period for evaluation), fresher data and quantitative assessment of the effects of policy and non-policy factors.

This study can, therefore, be considered as pioneering research in the field of Islamic finance, both in Sudan and in the context of developing countries. The

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principal aim of this study is to evaluate the effects of using the profit and loss sharing scheme to establish its role in improving the supply of funds for entrepreneurs.

Therefore, an empirical study based on the experience of the Islamic banking in Sudan is presented in this research. The experience of the Sudanese banks is chosen for the following reasons:

- (i) Sudan is chosen as the subject for this study, because the country is viewed as becoming one of the major players in the economic and political stability of the Middle East region. Sudan is now adopting a liberal economic policy attracting Arab investors from different countries in the region. In addition, among all Arab and Muslim countries, the Sudan has greater potential for growth in productive sectors, especially the agriculture and oil industry. This potential has not been utilised, partly because of lack of capital;
- (ii) The first generation of Islamic banks in Sudan was established in the 1970s. Also Sudan has more Islamic banks than other Islamic or Arabic countries, as there are more than 26 banks operating in Sudan; and
- (iii) The performance of the Sudanese banks is of special concern to the researcher, who as a lecturer worked at Sudan University's banking and finance department of the College of Business Studies.

1.3 Statement of the Problem, Objectives, and Research Questions

1.3.1 Statement of the Problem

The bulk of the assets of banks operating according to a paradigm of Islamic banking is represented by PLS transactions, i.e. mostly uncollateralized equity financing. As mentioned, these assets are far riskier than the ones represented by

non-PLS transactions, which are collateralized commercial or retail financing operations.

It is most important to recognize the impact of PLS modes of financing on Islamic banks, especially the fact that when Islamic banks provide funds through their PLS facilities, there is a recognizable default on the part of the agent-entrepreneur until PLS contracts expire, barring proved negligence or mismanagement on the part of the agent-entrepreneur. In fact, a default of PLS contracts means that the investment project has failed to deliver what was expected, that is a lower or no profit, or loss. In this case, the lower profit or loss is shared between or among parties according to the stipulated PLS ratios (Errico and Farahbaksh, 1998).

The lack of PLS modes of finance performance, because of managerial efficiency, can be considerable and may threaten the existence of Islamic banking, which is already facing strong competition. To shed light on the Islamic finance techniques and practice, this study undertakes an empirical study of the implications of using *musharakah* mode of finance in Sudan, which covers five main areas: First, it investigates whether the PLS contracts are dominating the Islamic banking system in Sudan in terms of using the largest percentage of the funds available. Second, the study evaluates the performance and its perceptions of *musharakah*. Third, it investigates *musharakah* management to recognise the obstacles and constraints. Fourth, it investigates the implications of using *musharakah* mode of finance. Fifth, it investigates the factors influencing decision making in Islamic banks in regard to *musharakah* finance.

1.3.2 Aims and Objectives

Hence, the broad aim of this research is to explore and evaluate the PLS mode of financing through *musharakah* in the Islamic financial system of the Sudan. To this effect, the study aims to examine the scope, techniques, policy, and performance of the *musharakah* method used by the Sudanese Islamic banks. This is expected to produce knowledge quantitatively and qualitatively regarding the activities of these banks so that a better understanding of the fundamental

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principles of this system can be reached. Further, the study aims to analyse the main obstacles facing Islamic banks in *musharakah* finance and aims to suggest possible remedies. Also, the study intends to analyse how staff characteristics, bank characteristics and overall environment affect the preferences and performance of *musharakah* finance through the banking industry. Specifically, the aim of the study is to closely examine the relations between performance and *musharakah* characteristics.

Also the objective is to investigate the perception of the implications of using *musharakah* mode of finance by the Islamic banks in Sudan and to provide an empirical assessment of these perceptions about *musharakah* characteristics, performance, preference and obstacles. The intention is to decide which among the potential determinants of performance appear to be important (convert for ranking). By so doing, the study extends the literature in several ways and fills an important gap.

The focus of the study is on two areas: On the first, the study focuses on an explanation of perceptions as it should be, according to conformity to Islamic ideology and principles. The second aspect deals with analysis of existing practice. This study attempts to analyse in detail some specific perceptions and subjects to explain the nature of the *musharakah* practice by building a meaningful and understandable model regarding the activities of the existing *musharakah* finance, which can be compared with the logical or analytical model for the purpose of bridging the gap between them.

Another purpose which is of some importance is to examine whether there is a discrepancy between the theory of and expectation from the *musharakah* and the other methods and the actual practice. In this regards, the analysis uses primary data gathered through a survey investigation via questionnaires and field studies. Moreover, an assessment of the past performance of the Islamic banks will be carried out to offer an indication of their potential future.

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To this effect, the research is expected to examine the wider environment within Sudanese banks work; investigate the main features of the credit policy controlling Islamic finance methods as well as determine the access to and use of credit by small-scale entrepreneurs.

After providing empirical evidence, that can be useful in provoking an informed debate on Islamic finance in Sudan and other countries about the characteristics, performances, constraints of *musharakah*, the research highlights the pros and cons of *musharakah* finance and draws the necessary policy to improve PLS finance and concludes by suggesting modifications for further fine-tuning.

1.3.3 Research Questions

The following questions are proposed to guide the collection, analysis and interpretation of data in line with the research aim and objectives. It is expected that the research will, in the end, provide answers to these questions to ensure the research is designed accordingly. In particular, the study sought answers to the following questions:

Research Question 1: What is the role of *musharakah* finance among the total Sudanese banking finance?

Research Question 2: Why is or is not *musharakah* the priority financial instrument in Sudan?

Research Question 3: What is the average age of *musharakah* projects?

Research Question 4: Why or why not do Islamic banks prefer short-term *musharakah* finance?

Research Question 5: What is the preferred economic sector for financing using *musharakah* instrument?

Research Question 6: Why or why not do Islamic banks prefer *musharakah* trade finance?

Research Question 7: What is the perceived financial performance of *musharakah* in terms of profitability?

Research Question 8: What is the perceived financial performance of *musharakah* in terms of risk?

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Research Question 9: What is the perceived impact of *musharakah* risk on the degree of the interference on management?

Research Question 10: What is the most preferred instrument among Islamic finance methods according to the respondents' perception?

Research Question 11: What are the possible factors influencing granting credits *musharakah* finance according to the perception of the respondents?

Research Question 12: What are the perceived possible factors influencing the distribution of bank funds among different Islamic finance instruments?

Research Question 13: What are the perceived factors causing non performing *musharakah* investment? And how can Sudanese banks over come these factors?

Research Question 14: What are the perceived factor(s) that cause(s) weakness in the follow up process of *musharakah* projects? And how can Sudanese banks over come them?

Research Question 15: What are the perceived factors determining the capability of the entrepreneurs to be offered *musharakah* finance?

Research Question 16: To what extent are the respondents satisfied with their bank's methodology for measuring the creditworthiness of entrepreneurs and project related risks?

1.4 Research Methodology Design

The principal method used to gather primary data in responding to the research questions is a questionnaire survey of staff in the investment department in the Islamic banks in Sudan. A period of about six months was spent in Sudan carrying out this fieldwork, and the objectives were three-fold: to collect all possible and available primary information on the *musharakah* as financed in the sampled banks; to gather all available related secondary information pertaining to the research work; and to conduct a survey questionnaire of the participating Islamic banks.

This research is regarded to be an explanatory research and evaluation research since it attempts to investigate the trend, development, performance, obstacles and prospects of Islamic finance in Sudan for evaluation purposes. This study uses sample survey as it was thought to be the most suitable way to achieve the

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research objective especially based on the nature of the data required and the purpose for which it was to be used. The study uses a combination of the literature studies and a survey investigation approach, which offers the most appropriate and satisfactory methodology in carrying out this study.

Data from Sudan, which fully adheres to interest-free principles of finance, is used to answer the research questions. The researcher used primary data mainly to suit the nature and purposes of the research which was to elicit respondents' opinions, perceptions and attitudes. The survey approach using questionnaire is thought to be the most appropriate technique in collecting the intended primary data. A short section evaluating the profitability and risk in the form of performance analysis is added in later chapters with the use of secondary data.

1.5 Limitation of the Study

It is important to clarify the concept of equity participation finance, for the purpose of this study the *musharakah* equity participation finance is one which establishes a partnership relationship between two or more entities (one of them is a bank) running a business in common with a view to profit. Therefore, neither the equity finance, which consists of a combination of sole proprietorship and partnership nor joint stock companies, nor cooperation is part of the scope of this study. In fact, this study is interested in *musharakah* finance through the Islamic banking. Thus, a number of issues related to the Islamic economic system are not considered in the study, as the study is not an overall evaluation of the Islamic financial or economic system. But the researcher finds that it is of some importance to the problem area to provide an understanding of some variables to analyse bank uses of funds. This study will concentrate on investigating the Islamic banking system in terms of its practice of Islamic finance methods.

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Apart from the limitations, the research cannot investigate Islamic banks across all Muslim countries. Therefore, the research will limit itself to the Sudanese experience only. The researcher, thus, limits himself to the following:

- (i) This study will be on Islamic finance *musharakah* instrument in Sudan only;
- (ii) The study is intended to cover the period between 1990 and 2005 (for the short secondary data analysis, regarding performance, the period is further limited to 1993-1999 due to data availability);
- (iii) The setting chosen and the main emphasis of the research is on an empirical investigation. A survey investigation via questionnaire will be carried out;
- (iv) The data is limited to a sample of banks.

The results of the survey are generally applicable to the rest of the Sudanese district around the country, based on the fact that the Sudanese society is homogeneous, and any segment of the population should be a fairly accurate representation of the population as a whole. Nevertheless, this study does not claim that the sample is a representation of all *musharakah* projects in other countries.

In addition, the study only focuses on investigating the perceptions of the investment department employees of the Sudanese Islamic banks. Therefore it does not include the entrepreneurs' perceptions.

1.6 Organisation of the Study

This study is composed of eleven chapters. **Chapter one** is an introduction to the study and highlights the aims and motivations of the study, the research questions, the operational concepts of Islamic banking and finance, the research design and methodology in addition to reviewing the types and methods used in data collection.

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Chapter two studies the common rules governing the *musharakah* partnership in Islamic jurisprudence. Discussion in this chapter is limited to the major opinions in the main four Sunni schools, *Hanafite*, *Malikite*, *Shafi'ite*, and *Hanbalite*.

Chapter three discusses the main features of *musharakah* when carried out in the banking system to finance potential entrepreneurs. This includes, profit and loss distribution, collateral provided, following up procedures, marketing *musharakah* projects, and some other concerns about *musharakah*.

Chapter four covers broadly the Sudanese economy and monetary policy. Hence, it discusses the performance of the Sudanese economy and demonstrates the important characteristics of the credit and monetary policy of the Central Bank of Sudan.

Chapter five focuses on the Sudanese banking industry, which provides an overview of the history of the Sudanese banking industry and its performance using some selected banking finance indicators.

Chapter six is the start of the field study and discusses the methodology applied. Hence, this chapter describes the research procedures for data collection both primary and secondary especially the survey questionnaire, and considers the advantages and disadvantages of this approach. It also describes the method of data analysis pursued in empirical analysis. Generally, the chapter discusses the main issues involved in survey design, data collection and data analysis. Furthermore, this chapter provides an outline of the research methods used in the fieldwork and presents a description of the study sample and the statistical techniques used to analyse the data as well.

Chapter seven analyses the profile of the Sudanese banks. This chapter identifies the structure of the Sudanese banks, the geographical distribution of its branches, and the market share of the *musharakah* fund among other finance methods. Also the chapter identifies the sampled banks under study and the banks selection criteria. In addition the official guidelines followed by the

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selected banks in granting *musharakah* fund are also considered as part of the bank's profile.

Chapter eight examines the sample characteristics and analyses the opinions of bank personnel towards banking activities. Hence, this chapter, firstly, presents the demographic and work related characteristics of the bank personnel, who have responded to the questionnaire conducted by this study including demographic and professional experience related information. Secondly, it also aims to identify *musharakah* management characteristics including the awareness of the *musharakah* product cost and pricing decision as well as the responsibility and objective characteristics of the banks when carrying out *musharakah* finance projects. Thirdly, it aims to study the longevity of *musharakah* projects.

Chapter nine discusses and analyses the preference and performance of *musharakah* finance. Therefore, the purpose of this chapter is to investigate the preference of different modes of finance especially *musharakah* finance as well as the performance of the *musharakah*. In addition it identifies all factors influencing the decision of taking finance through *musharakah*. The chapter determines the preference mode of finance, the preferred sector to finance *musharakah*, factors influencing granting credits and hindering *musharakah* investment and factors affecting the distribution of bank funds according to the different methods of finance. The perception of the *musharakah* performance is also discussed.

Chapter ten identifies the constraints and obstacles facing *musharakah* finance including the causes of non-performing *musharakah*, the lack of proper feasibility studies, factors determining the capability of the entrepreneurs to be offered *musharakah* finance, and measuring entrepreneurs' creditworthiness.

The final chapter, **chapter eleven**, is the conclusion, which also provides recommendations for the Islamic banking industry in Sudan. The purpose of this concluding chapter is to summarise and discuss the findings of this study and recommendations derived from these findings on theoretical, institutional, and

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practical levels. Also, questions arising from this study are used to propose an agenda for future research.

Chapter 2 Musharakah and Islamic Jurisprudence Fiqh

2.1 Introduction

From a very early stage in Islamic history, Muslims were able to establish a financial system without interest for mobilising resources to finance productive activities and consumer needs. The system to finance business activities was based largely on the profit and loss sharing (PLS) modes of *mudarabah* (passive partnership) and *musharakah* (active partnership). Deferred trading and interest-free loans were also used to finance consumers as well as business transactions. Historically *musharakah* and *mudarabah* were used not only by Muslims but also by Jews and Christians to the extent that interest bearing loans and other overly usurious practices were not in common use (Udovitch, 1970a).

Arab society during the early rise of Islam had very simple financing methods and forms of business peculiar to that society. The coming of the Holy Prophet (peace be upon him) saw the practice of *shirkah* already prevailing over the commercial activities in Arabia. He not only ratified it, but also did business himself on the basis of *shirkah*. After *Hijra*, the *Muhajireen* and the *Ansar* were declared by the Prophet (peace be upon him) to be brothers. Subsequently they joined as partners, in the form of *shirkah*, *muzara* and *musaqat*, in their trade and commerce. The nature of the transactions, in the various forms, is identical. The different nomenclature in Arabic refers to diverse activities such as *muzara* in agriculture, *musaqat* in gardening and *shirkah* in trade. The *shirkah* of capital and labour is called *mudarabah*. These four forms were so developed that they became independent institutions and the jurists formed detailed rules for them. Hence, there is a consensus of opinion among *Sunni* jurists of all schools of Islamic thought (*Hanafites*, *Malikites*, *Shafi'ite* and *Hanbalites*) that *shirkah* is a valid and legitimate contract in Islam. Jurists, however, differ over its form, conditions and other details (Saeed, 1999).

Chapter Two Musharakah and Islamic Jurisprudence Fiqh

Just as it is lawful for a Muslim to use his own wealth for any permissible purpose or to give it to a capable, experienced person to invest in a joint venture, it is also lawful for him to pool his capital with the capital of others for investment, trade, or any lawful business ventures. The Prophet (peace be on him) stated in a *hadith qudosi* that Allah, the Great and Glorious says, “I make a third with two partners as long as one of them does not cheat the other, but when he cheats him I depart from them”. (Reported by Abu Daoud and by al-Hakim, who calls it sound in Traditions (*sunnan*) of Abu Dawood, Book of Sales, No. 2936). “Third” refers to His help, inspiration, and blessing.

Classical Islamic law, which will be the main source for this chapter, was created during the first two centuries of the Islamic era and continued up to the beginning of the fourth century. Thereafter, all the future legal Islamic jurisprudence was relegated to commentary, explanation and interpretation of the existing jurisprudence.

Musharakah (partnership) is the first basic profit and loss sharing concept in Islamic banking together with *mudarabah*; the Qurán contains the root of the term *musharakah*, which is *shirk*, approximately 170 times, though none of these verses contains the term strictly in the sense of partnership in a business venture. Nevertheless, on the basis of several verses of the Qurán, particularly verses 4:12 and 38:24, as well as some reports attributed to the Prophet (peace be upon him) and his Companions, the validity of *musharakah* in business ventures is justified (Saeed, 1999).

Several sayings of the Prophet (peace be upon him) to his Companions indicate that some form of partnership was practised by the earliest Muslim community. These sayings merely refer to the existence of a form of partnership, without indicating any terms, conditions or concepts which may have been associated with this partnership. Given that these reports do not provide any details as to the valid terms and conditions of such partnership contracts, as they later came to be known in Islamic law, such terms and conditions, as they are defined and elaborated in *fiqh* are the product of *ijtihad* by Muslim jurists (Saeed, 1999).

In *fiqh*, the concept of *shirkah* is used in a much wider sense than the concept of *musharakah* used in Islamic banking which will be discussed later.

The objective of this chapter is to study the common rules governing the *musharakah* partnership in Islamic jurisprudence. Discussion in this chapter is limited to the major opinions of the main four *Sunni* schools, *Hanafites*, *Malikites*, *Shafi'ites*, and *Hanbalites*. So, this chapter covers the definitions and different types of *shirkah*, distinguishing features of *mufawadah* and *i'nan* partnerships, the rules governing the distribution of profit; loss and debt liabilities, the nature of the partnership capital, purchase; sale and expenses, the stipulation of management; securities and work, and lastly, dissolution of partnership.

2.2 Conceptual Definitions

2.2.1 Association between *Musharakah* and *Shirkah*

The word for partnership in Islamic law is *sharikah*. Some jurists prefer to use the word *shirkah* which means sharing in the terminology of Islamic jurisprudence (*fiqh*) (Nayzee, 1999). There is, however, no big difference in the meaning of the different applications of the word. The association of the word *musharakah* is rather limited, compared to the term *shirkah* which is more commonly used in Islamic jurisprudence (Usmani, 1999).

Nevertheless, in countries where English common law is applied, a distinction is made between partnership and companies or corporations with respect to terminology so as to identify the difference in the legal forms. In Sudan, the word *sharakah* is applied to mean partnership while the word *sharikah* is used for companies as well as corporations. To distinguish between legal forms, additional terms are used, such as *musahamah* for corporation and *mahdodah* for limited liabilities. Thus, a corporation is called *sharikah musahamah* (Oleynick and Alexander, 2001). This method of naming different legal forms of the business enterprise does not affect terminology alone; it has some conceptual implications as well which can occasionally be confusing.

In all of Islamic law, the liability in all partnerships is unlimited (in the present meaning), which implies that in all Islamic partnership types, the partners are liable in proportion to their share of the total investment. If loss occurs, partners, according to their shares, have to pay from their own private wealth to cover it. There is, therefore, no limit whatsoever to the amount of the partnership's liability. Each partner is responsible for his share of the partnership's liabilities regardless of what it amounts to, or by how much it exceeds the value of his own share of the company's assets (Udovitch, 1970b).

It should, however, be noted that Islamic financial institutions translate partnership as 'participatory financing', in order to put more emphasis on one particular aspect of *musharakah*, as the research will discuss later.

For the purpose of clarity, with regards to the basic concepts of *shirkah* and *musharakah*, it is essential to explain the meaning of the word *sharikah* and its types and *musharakah* will be discussed in detail in the next chapter.

2.2.2 The Literal Meaning of *Shirkah*

The word for partnership in *fiqh*, as stated earlier, is *shirkah* or *shirkat*. In the literal sense, the word *shirkah* has two meanings, which are mixing (*ikhtilat*) and partnership. In the first one (mixing), it refers to the mixing of the shares and capital contributed by the partners, by which one of them cannot be distinguished from another (Ibn Manzur, 1956). The second meaning describes *shirkah* as the contract of partnership itself, because it is the cause of mixing (Ibn Al-Humam, 1970). The technical meaning allocated to the word *shirkah* by the jurists does not go beyond these meanings, because partnership arises either through a contract or through the mixing of wealth. However, the researcher were not able to identify the technical meaning of all types of *shirkah* as it considerably varies.

2.3 Types of *Shirkah*

Jurists have divided the types of *shirkah* partnership into three kinds: *sharikat al-ibahah* (common sharing of things); *Sharikat al-milk* (co-ownership); and *sharikat al-'aqd* (partnership through contract).

2.3.1 Common Right to Acquire Ownership (*Sharikat Al-ibahah*)

Sharikat al-ibahah is defined as the common right of the people in ownership by acquisition, or gathering of things that are permissible (*mubah*) for such an acquisition and are not originally owned by anyone (Majallat, 1923). These things can pass into the ownership of individuals in two ways: by actual gathering or acquisition, like gathering firewood or the revival of barren lands; and by bringing about the cause of acquisition, like placing a pan for gathering rain water or throwing a net in the water for fish. It is noticeable that today such a partnership would be difficult to form. All things not owned by the citizens are owned or regulated by the state, except for things that are free like air or rainwater. Today, forests, land, lakes and all other things are owned by the state. Thus, an individual may not be permitted to throw his net into water for fish if the state has chosen to grant licenses for such an economic activity (Usmani, 2002).

2.3.2 Co-ownership or Property Partnership (*Sharikat Al-milk*)

Sharikat al-milk is defined as the existence of a thing in the exclusive joint-ownership of two or more persons due to one of the bases of ownership, or it is the joint claim of two or more persons for a debt that is due from another individual arising from a single cause (Majallat, 1923). In other words it means the joint ownership of a property without its joint exploitation, such as the joint ownership of a house transmitted, by devolution, to the heirs of a deceased person (Saleh, 1986). Jurists have divided Co-ownership or *sharikat al-milk* into two types: co-ownership in ascertained property and co-ownership in debt not ascertained by weight or measure or other means arising through inheritance or through exchange or through other means (Ibn Abidin, 1966). The first type is

the joint and exclusive ownership of two or more persons resulting from one of the causes of ownership, like purchase, gift, acceptance of a bequest, inheritance, or by the mixing (*ikhtilat*) of their property in a manner that does not accept distinction or separation (Majallat, 1923). By contrast, the second type occurs when two or more persons are owed a debt attached to the liability of another person, a debt that has arisen from a single cause. This is a common debt and is held in co-ownership between them. If the cause is not common, the debt is not in co-ownership (Majallat, 1923).

2.3.3 Partnership through Contract (*Sharikat Al-'aqd*)

Sharikat al-'aqd or partnership through contract is the same thing as partnership in law. It is to be noted, however, that there are different types of partnership in Islamic law. Islamic law attempts to assign separate rules for each type. *Sharikat al-'aqd* can be defined as a contract between two or more people for participation in capital and/or labour and its profits, or participation in transactions in someone else's capital and its profits, or participation in profit without participation in capital or transactions (Nayzee, 1999). Therefore, the emphasis is on the joint exploitation of capital and/or labour, the joint participation in profits and losses and where joint ownership is a consequence of, and not a prerequisite for, the formation of the partnership (Saleh, 1986). This explains that *sharikat al-'aqd* can be in both capital and labour, capital only, or labour only.

2.3.4 Distinction between Co-ownership or Property Partnership (*Sharikat Al-milk*) and Partnership through Contract (*Sharikat Al-'aqd*)

In law, *sharikat al-milk* is not referred to as a partnership, but as a co-ownership. Nor does co-ownership form the basis of partnership in law. In Islamic law there are many differences between them. The main differences appear to be in the relation between partners and the purpose of the *shirkah* (Nayzee, 1999). To sum up, while the purpose of *sharikat al-milk* in ascertained property is not necessarily sharing of profits, the purpose of *sharikat al-'aqd*, on the other hand, is the seeking and sharing of profits.

Secondly, the distribution of the relevant revenues or profits of *sharikat al-milk* always follows the ratio of shares (Al-Kashani, 1968). By contrast, as discussed later, in *Sharikat al-'aqd* this ratio may be altered.

Lastly, the partner in a *sharikat al-milk* is not an agent for other partners while he is in a *sharikat al-'aqd*. Consequently, in law, a co-owner may sell his interest to a third party, but a partner may sell his share in the partnership property of *sharikat al-'aqd* only with the permission of other partners (Nayzee, 1999).

2.4 Types of Contractual Partnership (*Sharikat Al-'aqd*) in Fiqh

When scholars study this sort of *shirkah* partnership they repeatedly differentiate such partnerships according to the object of the investments with no distinction between commercial and non-commercial (Saleh, 1986). Consequently, contractual partnerships are normally divided according to its object into three categories:

- (i) *Sharikat mal* (finance partnership), where the money is the main investment (Saleh, 1986);
- (ii) *Sharikat a'mal* or *shirkat al-abdan* (labour partnership) where the partners contribute their skills and efforts to the management of the business without contributing to the capital (Usmani, 2002) ; and
- (iii) *Sharikat wujuh* (credit partnership) where credit alone is used for partnership investment with no initial capital provided by partners. In *shirkat al-wujuh* the partners use their goodwill, their creditworthiness and their contacts for promoting their business without contributing to the capital (Saeed, 1999).

Both these forms of partnership, *Sharikat wujuh* and *Shirkat al-abdan*, where the partners do not contribute any capital, are confined essentially to small-scale businesses only. Each of these finance, labour and credit partnerships can take the form of an unlimited, unrestricted and equal *mufawadah* partnership or the form of a limited investment (*i'nan*) partnership.

The *musharakah* of the Islamic financial institutions is obviously finance partnership or, to use the terminology of those institutions, a 'participatory finance' where money is the main investment. In accordance with the terms of a 'participatory finance', the Islamic bank or institution will fund the equity capital, or the cash flow requirements, or both, for an agreed enterprise proposed by an entrepreneur client to the institution or bank. Profits will be shared between the two parties in the agreed ratio, and losses, if any, will be in proportion to the partners' shares in the partnership capital (Saleh, 1981).

Clearly, only the *Sharikat mal* (finance partnership) of the *sharikat 'aqd* (contractual partnership), only and specifically, is relevant to the present topic of the research. Since the subject matter of *mufawadah* and *i'nan* can be wealth, labour, or creditworthiness, the researcher will examine the rules that are applicable to *i'nan* and *mufawadah* partnerships with regards to wealth as subject matter.

2.5 Sharikat Mal (Finance Partnership)

All these modes of 'sharing' so far in the Islamic *fiqh* terminology are termed as '*shirkah*', while the term '*musharakah*' is not found in the *fiqh* books. This term *musharakah* has been introduced recently by those who have written on the subject of Islamic finance and it is normally restricted to a particular type of '*Shirkah*', that is, *shirkah Al-i'nan* of the *Shirkat mal* for the *Hanafites*; *Shafi'ites*; and *Hanbalites*, and *mufawadah* of the *Shirkat mal* for the *Malikites*.

Sharikat mal can be divided into partnerships with equal shares and partnerships with unequal shares. A partnership with equal shares is a partnership which is formed when the partners enter into a contract of partnership stipulating complete equality between them, and, after they have contributed the property which is to form the capital of the partnership, they maintain equality in the amount of their capital, and their shares of the profit. A partnership with unequal shares is formed when a contractual partnership is concluded without stipulating complete equality. For the majority, *Hanafites*; *Shafi'ites*; and *Hanbalites*, equal shares partnerships are called *mufawadah* and the unequal shares partnerships

called *i'nan*. By contrast, the *Malikites* School call the equal shares partnership *i'nan* and use *mufawadah* for the unequal shares partnership.

Since the topic of this research is to study *musharakah* mode of finance in which the Islamic bank and a customer combine their capital in a *musharakah* project to share the profit (which is almost analogous with *shirkat mal*), the researcher shall now dwell upon it, explaining the traditional concept of this type of *Shirkah*, breaking down the two types of this partnership namely *mufawadah* and *i'nan*.

2.6 Distinguishing Features of Mufawadah and I'nan Partnerships

The *shirkat mal* is a contractual partnership whereby two or more partners contribute to a capital fund combined with their labour effort to achieve profits. This type of *shirkah*, depending on its features, can be formed as either an *i'nan* or a *mufawadah* partnership. The *mufawadah*, according to the *Hanafites* is a partnership in which the partners enjoy complete equality in the areas of capital, management and right of disposition. Each *mufawadah* partner is both an agent of and a guarantor for his colleague. The *Malikites* concept of *mufawadah* is nearly the same as the *Hanafites* concept of *i'nan* partnership (Saleh, 1986), as will be seen later, as neither demands complete equality in capital, management and distribution of profit and loss. Contrary to the *Hanafites mufawadah* and similar to their concept of *i'nan*, some *Ibadi* jurists believe that equality of capital and equality of shares in the profits is not necessary (Saleh, 1986). To illustrate, for the *Malikites*, *mufawadah* denotes a general type of commercial partnership in which capital and profits are distributed in indefinite shares (Udovitch, 1970b). For the *Hanafites*, complete equality in all financial matters is a must for a *mufawadah* partnership, whether in respect to each partner's contribution to the joint capital, or to the share of profits and losses assigned to him. Thus, whether the partners invest equal amounts of capital but agree on an unequal distribution of the profits, or whether, conversely, they invest unequal amounts while contracting to divide the profits equally, the partnership is not, according to *Hanafites* law, considered a *mufawadah* (Al-Shaybani, 1884). Similarly, for *i'nan* partnership, equality is necessary for *Malikites*, but not for *Hanafites* or the other *Sunni* jurists.

For *Hanafite* jurists, it is not only the structural features which distinguish the *i'nan* from the *mufawadah* partnership. Each *mufawadah* partner is both the agent (*wakil*) of and guarantor (*kafil*) for his colleague. In the *i'nan* partnership, the relations of partners to third parties and those between partners are based exclusively on the principle of agency. Each partner is only the agent and not the guarantor of his colleague and this mutual agency is valid only in the area of commerce covered by their partnership or to the extent of their joint capital. To conclude, for *Hanafites*, *i'nan* includes a contract of agency only and does not include a contract of guarantee. Consequently, if at the time of the conclusion of the contract there has been no mention of a guarantee, the partners are not guarantors of each other (Majallat, 1923).

In comparison to the *mufawadah*, this difference confines the partners' freedom of action in the conduct of business and severely curtails the rights and claims of third parties toward the partner (Udovitch, 1970b). Consequently, the partners must be competent to conclude a contract of guarantee. Similarly, a *Malikites mufawadah* with unequal shares includes a contract of agency only and does not include a contract of guarantee. Consequently, if at the time of the conclusion of the contract there has been no mention of a guarantee, the partners are not guarantors of each other.

Since the researcher is studying partnership finance between a bank and its customer with no equality expected neither in capital (normally) nor in labour (definitely), then noticeably it is the *i'nan* partnership according to the majority of jurists, and *mufawadah* according to the *Malikites*, that is of interest to the research topic. Therefore, the research will study the common rules between both of them and will be referring to the *Malikites* only when he discusses *mufawadah* and the other three schools and mainly *Hanafites* when he discusses *i'nan* partnerships.

2.6.1 Derivation of the *Mufawadah* and *I'nan* Terms

2.6.1.1 *I'nan*

For the term *i'nan*, it is derived from the phrase (*'anna li*) which means "it presented itself to me or it appeared" (Udovitch, 1970b). It is also said that the term is derived from the reins (*i'nan*) of a pack animal, in the sense that the rider holds the reins with one hand and does something else with the other. Similarly, each of the partners transfers to his colleague the reins of disposition for only a portion of the joint capital. It could also be derived from the fact that a pack animal has two reins, one of them longer and the other one shorter; similarly, this partnership is permissible both with equal and unequal shares in the investment and profit on the part of the partners, and is therefore designated *i'nan* (Al-Sarkhasi, 1906).

2.6.1.2 *Mufawadah*

There are three meanings from which the term *mufawadah* could possibly have been derived. The first is the term *yofawidho*, which means "to delegate". Each partner makes a complete delegation of all acts to his partner in the entire stock of marketable goods (Al-Sarkhasi, 1906). It has also been said that it derives from the idea of dispersal, from: *yafeedh*, which means to "overflow" for example, when the water overflows, that it spreads out and disperses; or *yastafida* which means "it is distributed widely" (Udovitch, 1970b). Since this contract is based upon the dispersal of authority for all transactions, it was designated as *mufawadah*. The third meaning is that of equality. This contract is based upon equality of wealth and profit according to the majority of jurists (Al-Sarkhasi, 1906).

2.6.2 The Definition of the Terms (Technical Meaning)

2.6.2.1 *I'nan*

According to *Hanafites*, *Shafi'ites*, and *Hanbalites* jurists, *i'nan* is the participation of two or more persons, with the permissibility of stipulating inequality, through their work on their wealth, through their work on the wealth of another, or through their creditworthiness without wealth, so that the profit can be shared by them as agreed (Al-Kashani, 1968).

2.6.2.2 *Mufawadah*

According to the *Malikites* it is a partnership in which each partner confers upon his colleague full authority to dispose of their joint capital in any acceptable manner intended to benefit their association (Udovitch, 1970b). Indeed, this kind of partnership is to some extent identical to the Western joint liability partnership companies, in which there are two or more partners who jointly have the invited and unrestricted responsibility of debts and in all fields (Zineldin, 1990).

2.6.3 Equality of Work, Capital and Profit

Equality is not a condition for either capital or work for a *mufawadah* partnership according to the *Malikites* (Sahnun, 1905) or for an *i'nan* partnership according to *Hanafites*, *Hanbalites*, and *Shafi'ites*. The opposite is true; the *Malikites* request equalities in *i'nan* while the *Hanafites* request it for *mufawadah* as the majority of the *Shafi'ites* and *Hanbalites* regard *mufawadah* as invalid.

2.7 Distribution of Profit, Loss and Debts Liabilities

2.7.1 The Basis for Entitlement to Profit

Partnerships and all other forms of business organization are set up primarily for a single objective: the sharing of profits through joint participation. The jurists have different opinions about the basis of profit entitlement; the *Hanafites*

believe that entitlement to profit is either due to wealth or work or by bearing a liability for loss (Nayzee, 1999). The views of the *Hanbalites* are similar (Ibn Qudama, 1962). According to the *Malikites*, a partner is entitled to profit on the basis of wealth contributed to the partnership. In addition, in cases where a partner contributes work along with wealth to a partnership, his work is considered subservient to wealth. This means, therefore, that work in itself is not a valid, or at least independent, basis for entitlement to profit (Nayzee, 1999). Therefore, they do not permit the stipulation of a higher ratio of profits for excess work; the ratio of profit must always be proportional to the capital contributed. In place of excess profits, the working partner is entitled to reasonable wages for his additional work. The *Shafi'ites*, almost like the *Malikites*, permit a single basis for partnership and this is wealth. They, therefore, do not permit *sharikat al-wujuh*, which is based upon surety of liability to bear loss nor do they permit *sharikat al-abdan*, which is based upon labour (Al-Ramli, 1967).

2.7.2 Distribution of Profits

According to the basis for entitlement to profit set by jurists, *Malikites* and *Shafi'ites* believe that the ratio of the share of a partner in profit must conform to the ratio of his investment. The non-working party is not entitled to any share of the income, and can claim only the return of his investment and, if it happened to be in a form other than cash, some equitable rental fee for its use (Sahnun, 1905). But according to *Hanafites* and *Hanbalites*, the ratio of the profit may differ from the ratio of investment according to the agreement of the partner (Usmani, 1999). Moreover, no premium is placed on the quality of each partner's labour, and it is apparently only the quantity of work contributed by each that determines the division of profit (Sahnun, 1905). In other words, if they agree, it is permissible for the profit to not follow the partners' respective investments share. It is also permissible to stipulate for a share in the profit larger than that of his colleague (Nayzee, 1999, Udovitch, 1970b).

In addition, according to the four *Sunni* schools, there are several conditions concerning the profit sharing that must be expressly stated in the contract, otherwise it will be invalid.

These conditions are given below:

- (i) The ratio of profits must be stated specifically. The reason is that the main object of the contract is the sharing of profits, and if this is left vague, vitiation of the contract is a natural consequence (Al-Kashani, 1968).
- (ii) The profit should be a percentage of the whole profit and not a specific lump sum like one million pounds. This may also be expressed as one half, one third or one quarter. The reason is because the partnership might only achieve the amount (or less) set for one partner, which will lead to an unfair situation of a profit for one partner and nothing for the other (Al-Kashani, 1968).
- (iii) Profits should not be devoted to only one partner regardless of the share of capital for the same reasons as above.
- (iv) A larger stipulation should not be set for the partner who has less capital share and less labour share, taking into consideration both the skills and time for evaluating labour (Majallat, 1923).

2.7.3 Distribution of Loss

Loss refers to that part of the capital which is destroyed (Al-Sarkhasi, 1906) and will therefore be distributed in proportion to the capital invested in business and borne by the owners of the capital. The principle, agreed by the four *Sunni* schools of jurisprudence, that in case of a loss in joint-stock business, based on a *shirkah*, the loss will have to be shared in proportion to the capital invested (Siddiqi, 1985). Therefore, stipulating this in a contract would be not required. If, however, one of the partners assumes a share of the loss proportionally larger than that of the other, this is not permissible and absolutely invalid (Udovitch, 1970b).

Similarly, any damage suffered without any fault or negligence shall in any case be divided in proportion to the amount of the shares of capital. If any stipulation has been made to the contrary, no effect shall be given thereto (Majallat, 1923). This point is extremely important for understanding the problem of limited

liability of shareholders of a corporation as well as the limited partner in a limited liability partnership. Limited liability actually boils down to a violation of this condition of losses following capital contributed (Usmani, 1999, Nayzee, 1999).

2.7.4 Debts Liabilities

2.7.4.1 I'nan Partnership

As for the *i'nan* partnership according to *Hanafites* and some *Hanbalites*, it contains by default, mutual agency, but not mutual surety. By virtue of this, in a mutual agency; none of the partners is liable for that which is owed by his colleague. In an *i'nan* partnership, liability of the partners toward third parties is several but not joint; within the partnership, liability for obligations arising from partnership affairs is joint. This principle covers all the transactions on behalf of the company in which its members are free to engage (Al-Sarkhasi, 1906, Udovitch, 1970b).

The *i'nan* partnership is a contractual partnership whereby two or more partners contribute to a capital fund, either in money in kind, in labour or by combining some or all of these investments. Teachings of the different schools of law vary in this respect. For the *Hanafites*, *Malikites* and *Hanbalites* (Saleh, 1986) a contribution to the capital of *i'nan* partnership can take any of these forms of investment; it cannot be credit for the *Malikites* and *Shafi'ites* and it cannot be chattels (*urud*) nor labour for the *Shafi'ites* (Jaziri, 1963). Partners in an *i'nan* share the profits in the agreed manner and bear losses in proportion to their mutual contributions. Each partner is only the agent of and not a guarantor for his colleague(s) and this mutual agency is valid only in the area of business covered by the partnership or to the extent of their joint capital. The agency principle that results from *i'nan* is restricted to the partners' relationship, in the sense that only the partner who has concluded a transaction can sue the party with whom he has contracted, and the latter has no action except against the contracting partner (Saleh, 1986).

For *Hanafites* and some *Hanbalites*, the liability of the partners in an *i'nan* contract is unlimited for the debts of the *shirkah* when the partners are acting according to and within the authority, granted to them. Otherwise, if a partner abuses his authority, the liability of the other partner is limited to the extent of their shares. This is because *i'nan* partnership includes agency contract in itself. However if partners agreed on a surety, in which every partner is assuring and responsible for his partner's deeds, then a several and joint liability will be established (Nayzee, 1998). However, when the *shirkah* has not been expanded on borrowed capital or with goods purchased on credit, the financial liabilities of the investors are limited to the extent of their investments in the business. In other words, in the event of loss or bankruptcy, the maximum loss falling to a party will be equal to the capital invested by him. If, however, the *shirkah* has been expanded on borrowed capital or with goods purchased on credit, the financial liabilities of the partners investing capital in the business will exceed their capital investments and the limits of this excess will be determined by the decisions of the investors who have sought to expand the business by investing borrowed funds or by purchasing goods on credit (Siddiqi, 1985).

2.7.4.2 Mufawadah Partnership

As mentioned before, by the term *mufawadah*, *Malikites* jurists understand a partnership in which each partner confers upon his colleague full authority to dispose of their joint capital in any acceptable manner intended to benefit their association. The emphasis, therefore, is on the delegation of discretionary authority to conduct trade with each other's capital. Each partner is his colleague's agent and can act in all commercial matters with respect to his own and his colleague's property without the latter's prior approval. There is no dispute among the *Malikites* that the contract of partnership incorporates an unrestricted agency contract within it. In the absence of any contrary stipulation, for *Malikites* in *mufawadah*, partners are presumed to have discretionary powers in the administration of their joint capital. In all transactions which are recognized as a usual part of trade, each partner can act independently in the name of the partnership without exposing himself, in the case of loss, to any liability greater than that which would normally be his share (Sahnun, 1905). In

addition, the *Malikites* do not make a distinction between principal responsibilities and the agent responsibilities in an agency contract. Thus, if an agent buys for the partnership, both the agent and the principal can be sued. If, however, the agent does not have authority for making credit purchases according to his partnership contract, special permission will be required.

It appears that the *Malikites* are not satisfied with joint liability even for a normal credit purchase as they request that all the partners are present in such transactions. The liability, therefore, is not joint alone, it is also several. As each partner has acted for himself as well as for the other partners, each one can be sued for the entire amount and they can all be sued for it as well; it is up to the creditor. It is possible to conclude that the liability of the *mufawadah* partners is both joint and several; any obligation incurred on behalf of the partnership toward third parties by one of the associates can be claimed in full from any of the other partners since each one of them is liable for any obligation undertaken by his colleague in connection with their work (Udovitch, 1970b).

2.7.4.3 Limited Liabilities

The liability of a partner for the debts of a partnership is unlimited, and Islamic law does not legitimize the concept of limited liability as it is known in modern law for corporations and limited partnerships. Limited liability is the satisfaction of the debts of the partnership from the entire assets of the partnership including profits or from whatever is left after a loss has been made. This means that the creditors do not have access to the personal wealth of the partners, wealth that has not been contributed towards the capital of the partnership. This concept was allocated as a consequence of considering the partnership as a separate entity to their shareholders (Udovitch, 1970b). By contrast, compared with the corporation in modern law, which can be defined as an artificial person created by special authority and endowed by that authority with a capacity to acquire rights and incur obligations (Schamell, 1962), shareholders do not provide any kind of surety for the debts of the corporation (Nayzee, 1998). As mentioned before *Hanafite* jurists have made it clear that under *i'nan* no partner is a guarantor for other partners. By guarantor they mean the one who is responsible for the

fulfilment of the financial liabilities of another. Under *i'nan* no partner is liable for the transactions of other partners which fall outside the limits of the joint enterprise. The capital shares of the partners cannot be touched in order to meet the personal loans of a partner or credit purchases taken on by him in his personal capacity.

2.8 The Nature of Partnership Capital

The capital for a partnership can take the form of cash, goods, and/or other property. It cannot consist of forbidden commodities such as pork or wine, nor can the formation of the joint capital involve any kind of *riba* (translated as usury or interest) transaction (Sahnun, 1905). For all jurists in both *i'nan* and *mufawadah* the capital must be present. Present capital, in their view, is the wealth available for transactions and not necessarily present physically on the spot. Absent capital, or capital promised by one of the partners for future investment, is not to be considered until it is actually delivered (Udovitch, 1970b). This means that the partners can go ahead and conclude the contract even if the capital consists of receivables or wealth that is not available immediately, but the contract will be effective legally only when the transactions in such property are possible (Nayzee, 1999).

2.8.1 Cash

For *Malikites* if at a particular moment the values of *dinars* or *dirhams* of different types are identical, or if the difference between them is only minimal, these coins can serve as a valid partnership capital. Any change in the value of the coins subsequent to the contracting of the partnership is to be disregarded. The division of profits and losses as well as each partner's share of ownership in the joint property is determined by the value at the time of investment of the capitals of each. A partnership in which the investment of one party consists only of *dinars* and that of the other only of *dirhams* is not permitted. If, at the outset of their negotiations, the two parties happened to have in their possession *dinars* and *dirhams* of corresponding type, a partnership in these would be possible

between them since no element of money exchange would be involved (Sahnun, 1905, Udovitch, 1970b).

2.8.2 Goods

Capital can be provided in terms of goods except for a certain category of foodstuffs as all licit goods are eligible to become part of the joint capital of a partnership. For *Malikites*, all kinds of goods both measurable and non measurable ones (i.e. the commodities which cannot be compensated for by similar commodities), can be part of the capital if an evaluation according to the market price prevalent at the date of the contract has been carried for these goods (Sahnun, 1905). For *Shafi'ites* only measurable commodities, which if destroyed, can be compensated for by similar commodities in quality and quantity, can be part of the capital (Usmani, 1999). According to *Hanafites*, the measurable commodities can be part of the share only if they have been mixed with the other part of capital provided by the other partner (Usmani, 1999). Therefore, for both *Shafi'ites* and *Hanafites*, non-measurable goods can not contribute to the capital. It seems that the view of *Malikites* is simple and more reasonable, and meets the needs of modern business (Usmani, 1999).

2.8.3 Credit

Contrary to the *Hanafites* who permit credit partnership, *Malikites* consider partnership in obligations to be permissible; partnership is permissible only on the basis of property (*amwal*) or manual labour. In addition *Malikites* request that all prospective partners participate in the negotiation of credit purchase transaction to recognise its validity (Sahnun, 1905).

2.9 Purchase, Sale and Expenses

2.9.1 Purchase and Sale

As mentioned, for *Malikites* in *mufawadah*, the liability for obligations arising from the commercial activity of the partners is joint and several, even if the

particular transaction was conducted by one of them only. This applies to the rights and obligations pertaining to all purchases, sales, and debts, both those related to partnership business and those connected with the household affairs of the individual partners (Sahnun, 1905).

For *Hanafites* in *i'nan*, debts owed to and by each individual partner cannot be collected from, or claimed by, his associate. The same principle applies to the various problems connected with purchase and sales on behalf of the partnership. This is because the return of merchandise on these grounds is a right pertaining to the party directly involved in the transaction. A constituent does not have the right to dispute with the seller for something purchased by his agent (Udovitch, 1970b). If one *i'nan* partner grants a postponement in the payment of a debt owed to the partnership, the postponement is not bound to his colleague, and the latter can demand payment of his share either from the debtor or from his partner (Udovitch, 1970b). Either partner may rescind a purchase or sale made by the other if he does so before the transaction is consummated. *I'nan* partners also possessed the right of giving and taking pledges. However, only the partner conducting the sale, for example, could receive a pledge as a guarantee of payment. In case of non-payment, he would be obligated to compensate his colleague for the latter's share.

2.9.2 Expenses

Malikites believe that all business expenses should be covered by partnership funds in *mufawadah* contracts. Money spent or debts incurred for such activities as travel, or for the acquisition, transportation, and maintenance of company property, can be recovered from the joint capital (Udovitch, 1970b, Sahnun, 1905). The disposition of personal and family expenses of the *mufawadah* partners varies with their marital status. If both are single, or if both are married with families, all their regular personal expenses are on the partnership account. Otherwise, they are required to render an account of their personal expenses, and the difference between the single and married partner's expenditures are to be covered from the latter's personal funds. Personal expenses covered by the partnership include only the necessities of daily life; luxury items are explicitly

excluded (Udovitch, 1970b, Sahnun, 1905). Similarly, for *Hanafites*, business expenses like hiring services are in the same category as purchase; and since a partner possesses the right to buy, he also possesses the right to hire. In respect of hiring expenses, if a partner hires services in connection with their common trade, the hired person can only claim his fee from the partner by whom he was hired and has no claim against his colleague. The partner who did the hiring can then demand half of this fee from his colleague. This applies, if the hire is connected with their common trade and if they are partners in selling and buying. If it is not connected with their trade then an *i'nan* partner is not bound to pay for any service hired by his colleague. In respect of travel expenses *Hanafites* law allows the *i'nan* partner to charge them to the joint fund (Udovitch, 1970b).

2.10 Stipulation of Management, Securities and Work

2.10.1 Management

The normal principle of *shirkah (musharakah) partnership* is that every partner has the right to take part in its management and to work for it. However, the partners may agree upon a condition that the management shall be carried out by one of them, and no other partner shall work for the *musharakah*. But if such a condition has been put in the contract of *musharakah* in express terms, the sleeping partner shall be entitled to the profit only to the extent of his investment and the ratio of profit allocated to him should not exceed the ratio of his investment (Usmani, 1999).

In general, a partner in an *i'nan* partnership does not have the rights to enter into another partnership with the wealth of the partnership, nor to mix up his goods with the goods of the *shirkah*; otherwise he will be liable for any resulting loss. In addition he cannot give an interest-free loan (*qard-hasan*) to someone from the wealth of the partnership, nor can he accept a *qard* for the partnership nor can he purchase on credit beyond the limit imposed by the assets of the *shirkah*, as this would amount to *istidanah* (buying and selling on credit) for which special permission is required from the other partners (Nayzee, 1999, Majallat, 1923).

In an *i'nan* partnership based upon a general *wakalah* (agency contract); a partner has the powers to pledge/mortgage the assets of the partnership and also accept such pledges, and to enter into a contract of partnership with another on account of the *shirkah* (Nayzee, 1999). By contrast he can not give a *qard* or accept one for the partnership nor have the right to give the property of the partnership as a gift (Al-Kashani, 1968).

2.10.2 Securities and Guarantees

No security should be taken from the partner as such, from the point of view of Islamic law; only one sort of security is allowed, and indeed required, by some Islamic banks, such as the Sudanese banks. This is a security against the risk of negligence or wilful wrongdoing of the partner or his non-compliance with the terms of the partnership contract. The business risk inherent in the partnership and its outcome cannot be secured (Majallat, 1923).

2.10.3 Work

I'nan partnership requires that work in the capital of the partnership is stipulated for all the partners, but again it does not require all the partners to actually work. A partner has the right to give up work in the partnership with an excuse or even without an excuse. This act of the partner, if committed, has no bearing on the ratio of sharing profits stipulated in the contract. If work is stipulated for one partner alone, the contract will not be considered an *i'nan*, because of the lack of the requisite conditions, and the relationship between the parties will become a *mudarabah* constituted with the work *shirkah*, if the working partner is allocated a higher ratio of profits (Nayzee, 1999). Work possesses a specific value when the value thereof is estimated. That is to say, labour is valued when the worth thereof is assessed. The work of one person may be proportionately more valuable than the work of some other person (Usmani, 2002). If two partners in *i'nan* partnership stipulated that both of them shall work in the business, it may legally be agreed that one of them shall have a greater share of the profits than the other since the skill of one in trading may be greater and his output of work larger and more valuable. It may legally be agreed that work shall be in equal

shares, but that the profit devoted to work and wages shall be unequal and vice-versa, i.e. they can have unequal work with equal profit shares devoted for work (Majallat, 1923). For example the partners may legally agree that the work shall be performed in equal shares and that the profit devoted to work shall be divided by the ratio of two thirds to one third, the reason being that one may have more expertise in his craft, and consequently, his work may be better.

2.11 Comparison between the *Hanafites I'nan* and the *Malikites Mufawadah*

The *Malikites mufawadah* is almost identical to the simplest form of the *Hanafites i'nan* partnership (Nayzee, 1999), an *i'nan* based upon wealth with agency contract (*Wakalah*) alone, not a contract of surety (*Kafalah*).

Both contractual partnerships include a contract of agency. Thus, each of the partners is the agent of the other to deal with property, that is to say, to buy or sell, or to work for a wage for some other person. Consequently, in all partnership there is a condition that the partners shall be of sound mind and perfect understanding, as in the case of agency (Majallat, 1923).

In both contractual partnerships partners are trustees for the other, and the property of the partnership in the possession of either is considered to be property entrusted for safe-keeping. If the property of the partnership is destroyed while in the possession of one of them without any fault or negligence on his part, he is not liable to make up the loss to the share of his partner (Majallat, 1923). However, the two forms differ in the following respects:

- (i) The *Hanafites i'nan* permits the sharing of profits in ratios different from the ratio of the capital contributed. The *Malikites mufawadah* requires that profits always follow capital contribution.
- (ii) The *Hanafites* permit the stipulation of excess work by one partner, but do not insist upon actual work. The *Malikites mufawadah* requires work in proportion to the capital contributed and insists on actual work.

- (iii) The *Hanafites i'nan* permits, by virtue of the contract alone, a partner to buy on credit within, the capital limit. The *Malikites mufawadah* stipulates that special permission is needed for this and requires that all partners be present at the time of a credit purchase.

2.12 Dissolution and Termination of the *I'nan* and *Mufawadah* Partnership

The partnership contract can be terminated by the will of the partners or without their will. Termination of a partnership can occur either after the closure of the business or without closure of the business. Dissolution, in addition, can take place: by agreement; by mandatory dissolution; or by dissolution by the court. Generally, the following are the most common reasons which lead to the dissolution of a *shirkah* partnership contract.

2.12.1 Rescission (*Faskh*) by either Party or Dissolution by Court because of Violation of the Contract

Every partner has a right to terminate the *musharakah* at any time after giving his partner notice to this effect (Al-Kashani, 1968). The dissolution because of an abrogation of one of its partners does not become effective until the other partner becomes aware of his colleague's action. In this case, if the assets of the *shirkah* are in cash form, all of them will be distributed pro rata between the partners. But if the assets are not liquidated, the partners may agree either on the liquidation of the assets, or on their distribution or partition between the partners as they are. If there is a dispute between the partners in this matter i.e. one partner seeks liquidation while the other wants partition or distribution of the non-liquid assets themselves, the latter shall be preferred, because after the termination of *musharakah*, all the assets are in the joint ownership of the partners, and a co-owner has a right to seek partition or separation, and no one can force him to seek liquidation. However, if the assets are such that they cannot be separated or partitioned, such as machinery, then they shall be sold and the sale-proceeds shall be distributed (Usmani, 1999). If one of the partners wants termination of the *musharakah* without closing the business, while the other partner or partners wish to continue with the business, this purpose can be achieved by mutual

agreement. The partners who want to run the business may purchase the share of the partner who wants to terminate his partnership, because the termination of *musharakah* with one partner does not imply its termination between the other partners (Sahnun, 1905; Udovitch, 1970a; Al-Kashani, 1968). To conclude, the partnership may also be dissolved by one of the partners, provided the others are informed thereof. Cancellation by one without the knowledge of the others does not bring about the dissolution of the partnership.

2.12.2 Death and Incapacity of one of the Partners

The death of one of the partners results in the immediate termination of a partnership regardless of whether or not the surviving partner is aware of this event. The partners' rights and obligations are limited to the business transacted up to the time of their benefactor's death. Similarly, if any one of the partners becomes insane or otherwise becomes incapable of effecting commercial transactions, the *musharakah* is terminated (Al-Kashani, 1968). The Majallat (1923) states that the death of one of the partners, or his affliction by permanent madness, causes the dissolution of the partnership. However, if there are three or more partners, the dissolution of the partnership only affects the one who dies or goes mad and the partnership subsists as regards the others.

2.12.3 Complete Destruction of the Capital Wealth of the Partnership

When the subject-matter of the partnership is wealth, it is terminated when the wealth is entirely destroyed, before transactions on it have commenced. This is the case when it is formed with standard currencies like *dinars* and not a mixture of currencies (Usmani, 1999).

2.12.4 Termination of the *Shirkah* Period if it is for a Limited Duration

The partnership is terminated by the mutual consent of the partners, by the accomplishment of its aim and by the expiration of the term stipulated in the contract (Sahnun, 1905; Udovitch, 1970b).

2.13 Conclusion

A *musharakah* partnership is represented by *mufawadah* for *Malikites* and *i'nan* for the other schools when its subject matter is wealth. While all schools agree that loss distribution must conform to the investment ratios, only *Malikites* and *Shafi'ites* believe that the ratio of the share of a partner in profit must conform to the ratio of his investment.

The liability of the partners is unlimited for the debts of the *shirkah* when the partners are acting according to and within the authority, granted to them. The capital for partnership can take the form of cash, goods, and/or other property. However, it cannot consist of forbidden commodities such as pork or wine, nor can the formation of the joint capital involve any kinds of *riba*. The normal principle of *shirkah* partnership is that every partner has a right to take part in its management and to work for it. As far as the guarantee provided, no security should be taken from the partner as only one sort of security is allowed, and indeed required, by some Islamic banks, and that is a security against the risk of negligence or wilful wrongdoing of the partner or his non-compliance with the terms of the partnership contract.

There is, however, a substantial difference between *shirkah* as it existed in the early and medieval periods and as it exists now. This is to be expected. A dynamic system cannot continue to remain a replica of the past in an entirely different international and domestic milieu. Economies have become more complex and the international financial system has also followed suit in responding to the new challenges that it is facing. The financial system does not consist any longer of just banks. Hence, the discussion presented in this chapter provides a good ground for the *musharakah* in the modern world. The next chapter, therefore, will discuss modern *musharakah* as experienced presently.

Chapter 3 Theoretical Framework for Financing Entrepreneurs through *Musharakah* Scheme in the Banking System

3.1 Introduction

Having seen the rules governing *shirkah* and *musharakah* in the traditional *fiqh*, it is sometimes presumed that *musharakah* is an old instrument which cannot keep pace with the ever-advancing need for speedy transactions. In fact, Islamic finance principle has not prescribed a specific form or procedure for *musharakah*. Rather, it has set some broad principles which can accommodate numerous forms and procedures. A new form or procedure in *musharakah* cannot be rejected merely because it has no precedent (Usmani, 2002). Scholars and bankers revitalised these partnerships when Islamic banks began to expand in the mid-seventies. Islamic banking is presumed to be based on two new techniques that fully satisfy the Islamic law (*shari'ah*). The two legal forms are known in Arabic as *musharakah* and *mudarabah* business arrangements. *Musharakah* has been described as one of the best financial methods of Islamic banks as long as its terms and conditions are carefully observed (Saeed, 1999).

In the banking system, the method can be carried out in a slightly different way as the bank is a separate entity which usually finances thousands and thousands of entrepreneurs and businesses at the same time so it is almost impossible to carry out its duty as a normal partner in every contract. In general, the bank would contribute to the capital of the venture and leave the management to the partner (Saeed, 1999). *Musharakah* has been conceived in Islamic banking as a mechanism which could bring together labour and capital for the socially beneficial production of goods and services. It can be used in all occupations which are run according to profit motives. Although several writers on Islamic banking appear to use the term *musharakah* in the sense of participation in investment projects, the term is used by Islamic banks in a much broader sense

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(Ibrahim, 1987). For these banks, *musharakah* can be utilised for purely commercial purposes which are usually of a short term nature, or for participation in the equity of medium to long term projects.

It is important to clarify that the partnership finance meant by this study is the one which establishes a relationship between two or more persons (one of them being the bank) carrying out efforts to manage a business in common with a view to profit (Al-Harran, 1993). The definition provides us with the requirements for a partnership in that there must be a business, that it must be a continuing business (carrying on), and that it must have the capability of making a profit and there must be a positive effort. Neither the equity finance which consists of the combination of sole proprietorship and partnership nor joint stock companies, nor cooperation is part of the scope of this study.

This chapter discusses the main features of *musharakah* when carried out in the banking system to finance potential entrepreneurs.

3.2 Definition

Musharakah is a word of Arabic origin which literally means “sharing and jointly participating”. In the context of business and trade it means a joint enterprise in which all the partners share the profit or loss of the joint venture (Usmani, 2002). *Musharakah* in terms of Islamic banking can be defined as a “form of partnership where two or more persons (one of them being a bank) combine their capital and labour together, to share the profits, enjoying similar rights and liabilities” (Usmani, 1999).

3.3 Profit and Loss Distribution

3.3.1 Distribution of Profits

When a favourable return occurs in a *musharakah* project, the net return will be distributed to both parties according to the contract. This will mean that the

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proportion of the distributed profit between the partners must be predetermined and agreed upon at the time of signing the contract. It is worth mentioning that it is allowed to agree, upon distribution, a proportion different to the proportion of the capital contribution. The ratio of profit for each partner must be determined in proportion to the actual profit accrued to the business, and not in proportion to the capital invested by him. It is not allowed to fix an amount in a lump sum for any one of the partners, or any rate of profit tied up with his investment (Ibrahim, 1997).

In addition, if a favourable return occurs, the contract will specify the percentage of distributed profit as an exchange of management and the percentage of distributed profit as a capital price. To illustrate, if the total net profit is represented by P , then we will have

$$P = P_m + P_c$$

Where P_m represents the profits as an exchange of capital management and P_c represents the profits as an exchange of capital (Ibrahim, 2004). Each of these amounts will be distributed according to the agreed share.

The contract, as mentioned, will specify the percentages of the distribution devoted to the capital share, supposedly it is $R_{bc}\%$ for the bank then the entrepreneur will have to have $(100 - R_{bc})\%$ which represents the entrepreneur's profit devoted to capital (R_{ec}). Likewise the distribution devoted to the management will be R_{bm} for the bank and $(100 - R_{bm})\%$ is the entrepreneur share of profits denoted for management (R_{cm}). According to Ibrahim (2004), the following equations are recognised:

$$P_{bc} = P_c \times R_{bc}\%$$

$$P_{bm} = P_m \times R_{bm}\%$$

$$P_{ec} = P_c \times (100 - R_{bc})\%$$

$$P_{em} = P_m \times (100 - R_{bm})\%$$

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P_{bc} represents the share of the bank on the profit devoted to the capital and P_{bm} is that devoted to management, P_{ec} and P_{em} represents the share of the entrepreneur on the profit devoted to the capital and and to the management respectively. Therefore the total profit distributed for the bank (P_b) and entrepreneur (P_e) will be

$$P_b = P_c \times R_{bc} + P_m \times R_{bm}$$

$$P_e = \{P_c \times (100-R_{bc})\% \} + \{P_m \times (100-R_{bm})\% \}$$

This distribution can be done in another way when the profit devoted to management for both parties refers to the total net profit in the agreement. In such cases we have the total net profit 100% distributed to four collections as a percentage of the 100% as follows

$$R_{bc} + R_{bm} + R_{ec} + R_{em} = 100\%$$

$$P = P_{bc} + P_{ec} + P_{bm} + P_{em}$$

Therefore the total net profit distributed to the entrepreneur (partner) will be equal to the combination of his/her profit denoted for the management and the capital share.

However, it is possible that if a partner puts into effect more effort, or has more experience, he or she can take an additional percentage of the profits in lieu of his labour/expertise as well as the capital, not only the capital share.

3.3.2 Losses

Losses, on the other hand, have to be distributed according to the capital contribution. In another words, losses are distributed according to the investment shares even if it is different to the profit distribution (Ibrahim, 1997).

Therefore,

$$L_b = (C_b/C) \times L$$

$$L_e = (C_e/C) \times L$$

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where L_b represents the bank's share of loss, L_e the entrepreneur's share of loss, C_b represents the capital share of the bank and C_e the share of the entrepreneur., C is the total capital, and L represents the total loss.

3.3.3 Management Share of the Profit (*Hamesh Al-Edarah*)

Profit-sharing ratios are determined by many factors. One of which is an entrepreneur or firm's past and expected performance. Banks do not claim a share in the profits on an equal footing, which otherwise would mean sharing profits in strict proportion to the bank's financing of the capital of an entrepreneur. In a *musharakah* practice, the bank's role is limited in most cases to the provision of capital, whereas the customer, besides providing his share of the capital, also uses their labour, skill, enterprise and expertise.

Therefore, the contract rules evaluate the contribution of the management, labour and skills by devoting and specifying a portion of profit for it. This portion is called management share of the Profit (*Hamesh Al-Edarah*). The management bonus is payable to the entrepreneur under one of two cases, either on the basis of the whole profit regardless of its quantity or on the basis of achieving the projected profits. If profits fall below the projection, banks may allow a management share of profit at a lower rate rather than cancelling it altogether. Consequently the entrepreneur who achieves a higher rate of profits can earn a higher percentage of bonuses, which, as mentioned, shall be specified in the agreement (Akhtar, 1997).

Broadly speaking, a *musharakah* contract determines the management share of the profit for both parties, the bank and the customer, through mutual agreement. However getting a fair proportion of the profit is a problem, as the entrepreneur will try to overvalue his management effort and then accordingly he will ask for a high percentage of the profit. By contrast, the bank will try to underestimate his effort. Thus, a proper and fair methodology and calculation is needed and the estimation of the management share of the profit should not be left entirely to negotiations.

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Ibrahim (2004) suggested two approaches for the calculation; the residual approach and the imputed market share approach. The residual approach requires knowledge of the rate of return on each unit of the capital invested in previous similar projects. Subsequently, we have to deduct the share profits from the total expected profits and then divide the result by the total expected profit (Ibrahim, 1999). To have the management profit as a residual requires knowledge of rate of return on each unit of the capital invested in previous similar projects. To illustrate, we can denote management profit by PM , the expected profit by P , capital investment by C , and lastly, the rate of return R_c . Thus in this approach, according to Ibrahim (2004), an estimation of the share profit can be calculated from the product of the volume of capital invested multiplied by the rate of return on each unit of capital (Ibrahim, 1999). The subsequent equation to estimate the management share of the profit can be obtained from the following:

$$PM = \{P - (C \times R_c)\} / P$$

Additional incentive to the entrepreneur can be granted, whereby the bank can determine a maximum rate of return of total capital used in the project, above which the bank will be ready to sacrifice additional profit for the partner. In the current situation, the partner sometimes gets this incentive through increased management share, over and above the limit determined by the contract. However, the modification outlined is neither operational nor easier to calculate as it is not easy in many profit and loss cases to calculate either the expected profit or the expected rate of return per unit of capital.

In the second approach, the imputed market share approach, the evaluation will be made through using the current local market price divided by the total expected profit and, therefore, the profit can be calculated using the following equation:

$$PM = CLMP / P$$

where PM is the management profit, P is the expected profit, $CLMP$ denotes the current local market price. A weighing system can be used for factors such as qualifications, experience, and volume of capital, sensitivity of the project and

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additional incentives for the management (Ibrahim, 2004). If the project is wholly managed by the entrepreneur, the management share of profit, in addition to his profit share. If the bank is involved in management, part of the fees is paid to the bank. The management share usually ranges between 10% and 30% of the profit, depending on the entrepreneur's bargaining power and on the nature of the project (for example, if the activity requires special skills the share of the entrepreneur is greater).

3.4 Guarantee (Collateral)

3.4.1 No Collateral Needed (Intangible Guarantee Concept)

Profits produced in *musharakah* are not guaranteed, and as a result, the entrepreneur does not assure, secure or guarantee profits. Therefore, it is possible to conclude that *musharakah* does not require strict collateral guarantees and does not leave the partner (entrepreneur) with a heavy burden of debts, post-dated cheques or any other kind of obligations. For this reason, concentration should be on certain factors, among which are the feasibility of the project, the skills of the customer and his history and lastly the objective situation of the market and its risks (Abdouli, 1991). Taking the personal features of the potential entrepreneur as a part of the factors can be considered as an intangible guarantee. No doubt, this increases risks on one hand, while promoting a new service on the other hand. Specifically, by taking intangible assets, such as education, skills, experience, and honesty, as collateral, Islamic banking breaks this discriminative barrier and offers an equal opportunity to all potential producers to improve their well-being and that of the society.

It has been observed that the existing banking institutions prefer to grant financial facilities to those clients who, apart from enjoying a good business reputation, are also able to offer sufficient collateral security mainly in the form of valuable assets. This practice seems quite reasonable from the risk point of view, however, the non-tangible collateral holders are unjustifiably deprived of obtaining the necessary financial accommodation. The existing practice of

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demanding collaterals for the purpose of granting financial accommodation stems from the fact that Western Banking institutions are primarily concerned with profitability rather than social imperatives (Abdouli, 1991). The imposition of tangible collaterals as a necessary condition left small businessmen and farmers trapped in a vicious circle: they cannot get access to finance unless they offer sufficient collateral, they cannot possess tangible collaterals unless they build a strong productive base; they cannot improve their productive base unless they get access to finance; back to the starting point they cannot get access to finance unless they offer sufficient collaterals. Hence, there is no solution for the endless vicious circle. Besides this, there is no real consideration for their management skills or the feasibility of the project, since you can get the credit as long as the risk is low and the capital with its interests is well guaranteed (Abdouli, 1991).

This raises the fundamental question of whether intangible assets such as education, experience and skills can be regarded as equal collateral as less than tangible assets. The answer depends very much on the banking system prevailing in the society as well as the practice carried out. By using the *musharakah* mode of finance in the Islamic banking system, the answer might be yes. Islamic banking balances the priority of the needs of society and common interest with individual profit and private interest. Since the primary concern of the banking institution is both the maximization of profitability and of social imperatives, the tangibility of assets, as a pre-requisite to accessing finance loses its importance. Moreover, the granting of credit to an educated, yet financially poor person could be even more beneficial to both social justice and long term growth.

Some successful practices of lending without collateral for small businesses might prove the possibility of such a theory. One well-known success story is that of Grameen Bank in Bangladesh, which charges a lower market rate of interest to finance small and medium enterprise SMEs, without the need for collateral. It is maintained that the crucial factor in the success of the Grameen model is a cheap system of assessing creditworthiness, through local knowledge and group pressure (Ibrahim and Vijaykumar, 2003). Some suggestions advised

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to use the group lending idea in financing *musharakah* to small and micro business in order to reduce the administrative burden on bank staff and at the same time provide alternative security against possible default (Abdalla, 1999). *Musharakah* agreements could be concluded individually or with members of a group of five clients for example, who mutually select each other before applying to the bank. Group collateral would be in the form of security required by the bank against fraud or misuse of funds. Monitoring of *musharakah* could be undertaken by the group leader in collaboration with bank staff. Each group which fully honours its commitments could be rewarded by a larger future “finance” to each member of the group. This would constitute an additional incentive for honouring commitments (Abdalla, 1999). Consequently, this will be serving the overall banks favour.

However, this proposal does not give a solution for financing medium and large enterprises. In addition, the price which might be paid here is high cost and high risk, as following up many financed projects on the profit and loss sharing scheme might increase both the risk and the cost.

3.4.2 Tangible Guarantee

Nonetheless, in most practices, the bank (the financier) who does not usually perform in a full management capacity, normally asks for a guarantee against any losses caused by the partner as a result of his mismanagement or negligence.

Therefore, the customer might have to provide acceptable collateral, such as:

- (i) A real estate guarantee of a value equal to or more than the volume of financing;
- (ii) A bank ownership guarantee, which is used when the bank finances a means of transport through a diminishing *musharakah*, in which case the vehicle is registered as a property of the bank until the partner has paid all the instalments;

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- (iii) Two reputable guarantors (personal guarantee of a third), and he or she should sign promissory bank notes; and
- (iv) In the case of financing raw materials, the bank usually supplies only part of the raw materials to the partner, depending on his or her payment of instalments (Ibrahim, 2004). In case of *musharakah* for exporting or importing, and in order to secure himself from any negligence on the part of the customer, the bank may put a condition that it will be the responsibility of the customer to export the goods in full conformity with the conditions of the Letter of Credit. In this case, if some discrepancies are found, the exporter alone shall be responsible, and the financier shall be immune from any loss due to such discrepancies, because it is caused by the negligence of the exporter (Usmani, 2002).

Alternative types of security against possible misuse of funds could be introduced, e.g., pawning of valuable possessions (such as jewellery) when lending to female entrepreneurs.

In all cases, being the customer's partner, the bank will be liable to bear any loss which may be caused due to any reason other than the negligence or misconduct of the customer (Usmani, 1999).

3.5 Types of Modern *Musharakah*

Partnership financing can be categorized according to the duration of the project and or the nature of the project. Depending on its duration, it can be classified as a short, medium or long term *musharakah*. According to the nature of the project, it can be classified as impermanent, permanent and diminishing *musharakah*.

While in a permanent continuous *musharakah*, the partnership is supposed to exist forever and the shareholder might be looking for either capital gain, or profit, or both. In an impermanent partnership, it finishes within a specific period mentioned in the contract, or defined by the purpose of the project, or by

finishing a single transaction. In an impermanent partnership the shareholders mainly look for profitability. A diminishing partnership is one in which the bank's share in the partnership diminishes gradually through repayment, leaving the venture/asset/project to be wholly owned by the client.

3.5.1 Types of the Partnership *Musharakah* According to the Duration of the Project

Musharakah partnership can be for either an indefinite period, as in the case of the stock of joint stock companies, or a definite (short, medium or long) period as in the case of participatory finance through *musharakah* when it is for a specific period, or shares in partnerships when only profits are targeted not the capital gain (EI-Bhasri and Adam, 1997). A short-term financing is usually for the financing of working capital for one production period, season, fiscal year, or even a certain operation which involves a production period ranging between 3 and 12 months' duration (Al-Harran, 1997). The long-term financing covers financing of capital assets extending over a period of more than three years.

3.5.2 Types of the Partnership *Musharakah* According to the Nature of the Project

3.5.2.1 Impermanent Normal *Musharakah* (for a specific period)

An impermanent *musharakah* agreement is normally for one specific purpose, such as the purchase and sale of a machine or a commodity. Both the bank and its partner contribute to the capital, but it is the partner who undertakes the management of the buying, selling, marketing and account-keeping related to the transaction. The bank's function is to finance its share of the transaction, to provide necessary banking services like the opening of letters of credit where necessary, and to monitor the progress of the *musharakah* through the current account and other periodic progress reports from the partner (Usmani, 2002). An impermanent normal *musharakah* is usually used for commercial purposes. A commercial *musharakah* contract is useful for an Islamic bank as it can be

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liquidated quickly, the turnover of capital is higher, and therefore, the return will also be generally higher. The bank's activities in advancing finance on the basis of a commercial *musharakah* to a large number of ventures; serve to diversify and minimise risk in its investment operations. Impermanent normal *musharakah* partnership financing can be either for financing of a single transaction, financing of working capital or sharing in the gross profit only.

3.5.2.1.1 Financing of a Single Transaction

Musharakah can also be used for financing a single transaction. This instrument can be employed as an example for fulfilling the day-to-day needs of small traders and financing imports and exports. This is demonstrated when the exporter (the entrepreneur) has a specific order from abroad in which the sale price of the exported goods is well known before hand. Since the exporter doesn't have the ability to, or does not want to, finance the whole transaction, he might apply for *musharakah* finance. The bank can easily calculate the expected profit and, if it is decided to take it further, both of them will share the amount of export bill at a pre-agreed percentage as well as sharing the profit according to the predetermined ratios and sharing the loss according to their share of the capital (Usmani, 1999).

3.5.2.1.2 Financing of Working Capital

In this situation, the customer would have an asset from which he can make revenue but he does not have the ability to finance the working capital. So he seeks the finance needed from the bank on the basis of sharing the production brought out from this project according to their contribution. The assets will be hired for a suitable period. The depreciation of the asset for the whole *musharakah* period will be calculated, and added to the capital share of the partner. All liquid and non-liquid assets of the business are evaluated, and the profit may be distributed on the basis of this evaluation. The net income is distributed in accordance with the agreement of the contract (Usmani, 2002).

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The profit can be determined before all the assets of the business are liquidated, in case the working partner has purchased the share of the financier in the assets of his business, and the price of his share can be determined on the basis of valuation, keeping in mind the ratio of the profit allocated to him, according to the terms of the *musharakah*. In case of loss, however, any decrease in the total value of the assets should be divided between them exactly according to the ratio of their investment. The working capital finance therefore, caters for both production and management, thus leading to increased incomes for income groups which do not own capital (Usmani, 1999).

3.5.2.1.3 Sharing the Gross Profit Only

In a business with a large number of fixed assets provided by the two partners (industrialists), particularly in a running industry, it is easier to finance *musharakah* using the rule of sharing the gross profit only as it will be difficult to evaluate all the assets and calculate indirect expenses, like the depreciation of the machinery, salaries of the staff, etc., which might cause accounting problems and might lead to some disputes between partners. *Musharakah* can be used to solve difficulties when the parties may agree on the principle that, instead of net profit, the gross profit will be distributed between the parties, that is, the indirect expenses shall not be deducted from the distributable profit (Usmani, 2002). All the indirect expenses developed from any assets shall be borne by the owning partner of these assets, and only direct expenses (like those of raw material, direct labour, electricity etc.) shall be borne by the *musharakah*. If the assets were provided by one partner (industrialist), only the percentage of his profit may be increased to compensate him to some extent otherwise the parties may agree that the *musharakah* portfolio will pay an agreed rent to the partner for the use of the assets, like machinery and the building owned by him. This rent will be paid to him from the *musharakah* fund irrespective of profit or loss accruing to the business.

Hence the arrangement of sharing the gross profit and excluding the indirect expenses may be justified on the grounds that, in such a case it is not possible or

it is difficult to differentiate between the costs belonging to *musharakah* and the costs belonging to other operations, and the whole cost of these expenses cannot be imposed on the *musharakah* only.

3.5.2.2 Diminishing Musharakah: (Decreasing Participation)

Decreasing participation or diminishing *musharakah* is defined as a partnership whereby the bank enables the partner to gain ownership of the project gradually, according to the conditions set out in the *musharakah* contract. This contract will gradually lead to the entrepreneur's ownership of the asset which was the subject of the *musharakah* project solely, as he will buy the bank's shares until he becomes the sole owner of the asset. Customers of this form of *musharakah* are those who are not interested in the bank's continued co-participation in their projects, and who wish to gain ownership of the project in the shortest possible time. The financier (the bank) makes a binding promise to sell its ownership shares of the enterprise in installments (Boualem and Khan, 1995).

The entrepreneur voluntarily buys the share of the financier at the prices prevailing at the time of sale, so that at the maturity of the contract, the entrepreneur becomes sole owner of the project (Boualem and Khan, 1995). The researcher assumes that entrepreneurs prefer to own the enterprise in the first instance. It has been argued that in certain economic activities the need for the contractual and gradual termination of the financier's ownership is necessary. These activities include, for instance, entrepreneurial and investment promotion activities, developing agricultural firms and housing (Usmani, 1999).

The entrepreneur enters into a diminishing *musharakah* under a *Shirkat Al-milk* (joint ownership) agreement with the bank. The customer pays, for example, 20% as the initial share to co-own the asset (i.e. a house, etc.) whilst the bank provides the remaining balance of 80%. The customer will then gradually redeem the financier's 80% share at an agreed portion, until the house is fully owned by the customer.

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Secondly, the bank leases its share (80%) in the house ownership to the entrepreneur under the terms of *ijarah*, i.e. by charging rent. The entrepreneur agrees to pay the rent to the bank for using its share of the property, or the entrepreneur can buy the shares held by the bank at the end of each financial period, raising his share to 100%. The periodic rental amounts will be jointly shared between the customer and the bank according to the percentage of share holding at the particular time, which keeps changing as the customer redeems the financier's share (Boualem and Khan, 1995). The customer's share ratio would increase after each rental payment due to the periodic redemption until eventually fully owned by the customer.

Bendjilali and Khan (1995) and Usmani (2002) basically agreed on the implementation of diminishing *musharakah*. They argued that the product would help people rely less on other financing methods (such as *murabahah*).

While the instalments should be fixed from the beginning, the price of the asset and the inflation might affect the evaluation of the asset. The evaluation of the fixed assets in a diminishing (self-liquidating) *musharakah* needs a modification. Banks do not usually re-evaluate the asset at different times when part of the repayment is made. Inflation is not taken into account, and hence a diminishing *musharakah* is to the disadvantage of the bank. Re-evaluation of the assets should be undertaken and the volume of payment can be considered as a ratio of the value at the time of payment. For full payment of the value of the asset, the addition of these ratios must be equal to unity. As suggested by Ibrahim (2004), if P_1, P_2, P_3, P_4 and so forth are payments in periods 1, 2, 3, 4, respectively, and V_1, V_2, V_3, V_4 , and so forth are values of the asset in each payment period respectively, then at the time of full payment,

$$P_1/V_1 + P_2/V_2 + P_3/V_3 + P_4/V_4 + \dots = 1$$

Adjustment of the partners' shares has to be modified each period in accordance with the changes that may have occurred after each part payment (Ibrahim and Vijaykumar, 2003).

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It should be stated that the concept of diminishing *musharakah* is not confined to home ownership only. It can also be applied to other forms of acquiring assets such as buying a car or a taxi for earning income by using it as a hired vehicle (Meera and Abdul Razak, 2005).

3.5.2.3 Permanent or Continuous Participation

Musharakah can also be adopted for continuing businesses. The partners agree on the share of the profits to be allocated to the entrepreneur for his management, and the balance is shared in the same proportion as their respective investments (Harper, 1994).

3.6 Differences between *Musharakah* and Conventional Partnership

Among the many differences, there are two which stand out between the conventional partnership and the *musharakah* form of partnership. These are the likely limitations of the period of contractual *musharakah* form of partnership, and the liability for losses in the two forms of partnership. Whereas conventional partnership is usually not specified for a limited period of time, *musharakah* is. In limited conventional partnership, one partner can have unlimited liability beyond his/her capital contribution. In *musharakah* all partners have unlimited liability (Ibrahim, 1999).

However, if a *musharakah* is registered according to company law, then the limited liability of their shareholders will apply. They cannot be held liable for more than the amount of capital they have invested. This requirement makes it necessary to regard the *musharakah* as an entity separate from the individuality of the shareholders. This common practise law (*urf*) has given way to safe and stable *musharakah* resulting in big commercial organizations and flourishing businesses, while the liability is not limited if it is recognised as a partnership (Al-Harran, 1995b). However, most of the short term *musharakah* agreements are considered as partnerships, which means no limited liability is valid. Hence, if negative returns and losses occurred, liability will extend to the partners'

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private money collectively, regardless of their actual contribution in capital and management. In addition to these differences, in *musharakah* loss distribution, partners can not agree upon a ratio of distribution different to capital share, but in partnership they can. While it is allowed to fix the amount of profit for one partner in a conventional partnership, the profit should be distributed using a ratio in the *musharakah* scheme. To conclude, *musharakah* is just a kind of conventional partnership with special conditions.

3.7 Follow-up Procedures and Supervision

Broadly speaking, effective bank supervision is the key to achieve financial efficiency and stability. The key objective of supervision is to maintain stability and confidence in the financial system, thereby reducing the risk of loss to depositors and other creditors. This remains especially in PLS modes as the banks face moral hazards and adverse selection. Staff should encourage and pursue market discipline, and enhance market transparency and surveillance (Khan and Ahmed, 2001). Therefore, staff must gather information both onsite and offsite its partnership projects, and must practise their authority to enforce decisions whenever needed. Therefore, the staff especially those working in supervision and following investments, must understand the nature of the business undertaken by banks and entrepreneurs and ensure as much as possible that the projects and the risks incurred by the customer are being adequately managed. Effective banking supervision requires that the risk profile of individual customers be assessed and supervisory resources allocated accordingly. Supervisors must ensure that banks have resources appropriate to undertake risks, including adequate capital, sound management, effective control systems, and accounting records (Khan and Ahmed, 2001).

Effective supervision of banks ensures that projects invested function safely and soundly, so that the financial system can attain the full confidence of the bank's intermediation role. Supervisory systems are expected to depend on the socio-political and legal frameworks prevailing in different countries. Hence there cannot be a standardized supervisory system to be followed in all jurisdictions.

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Different countries use different methods and approaches to assess bank risks. These approaches are however, converging on one important point, namely, risk-based formal and systematic supervision shall gradually be adopted in order to make supervision effective (Khan and Ahmed, 2001).

To carry out this mission, Islamic banks also need help in the field of training. Currently, every bank has to arrange its own training programme. The central banks in Muslim countries could help by initiating a programme to train the staff of all banks in Islamic banking, thereby reducing the overhead costs of these banks. The central banks may also make arrangements for the training of businessmen and entrepreneurs in the maintenance of proper accounts and in having a proper understanding of Islamic banking. A programme to inform the public about the nature of Islamic banking could also be very useful (Chapra and Khan, 2000).

The establishment of shared institutions to perform the various tasks that these banks have to perform themselves at present is one of the most indispensable needs of Islamic banks. The establishment of such institutions will help to reduce the overhead costs of Islamic banks and raise their profitability. Most Muslim countries do not have private credit rating agencies to provide banks with information about the credit rating of counter-parties. Without such information, it will not be possible for these banks to move into the relatively more risky modes of *mudarabah* and *musharakah* financing. The establishment of such agencies will also greatly help enhance market discipline (Chapra and Khan, 2000).

Investment departments' staff should regularly visit *musharakah* projects and check bookkeeping, marketing of products, account receivable and collection procedure. These arrangements tend to ensure the safety as well as the profitability of the bank's investment. The bank should constantly watch its interest by focusing on the overall performance of the project.

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Follow-up and close supervision is one of most important factors contributing to the solution of problems and the elimination of obstacles that face the partner entrepreneur in the running of operations and the marketing of the finished product. Follow-up also limits the chance for any possible dishonesty on the part of the partner (e.g. unrecorded sale of the product or materials, or tampering with the records, etc.) (EI-Bhasri and Adam, 1997).

One of the main problems facing *musharakah* financing is the increasing burden of monitoring and follow-up, especially with the expansion of bank operations. Another important aspect is the ability of the bank to recruit the right type of personnel, those who are dedicated, qualified, competent, patient and business-minded. This remains to be the biggest challenge; the success of *musharakah* depends, to a great extent on building trust between the bank and its partner to avoid fraud and dishonesty. How a bank could build such trust remains another challenge (Abdalla, 1999).

In line with this, according to Ibrahim (1999): the bank requires the *musharakah* entrepreneur to observe the following conditions:

- (i) A proper bookkeeping system should be followed which reflects bookkeeping and accounting records, administrative activities, marketing policies, accounts receivable as well as collection procedures;
- (ii) There should be a separate bank account for the joint venture;
- (iii) Project materials should be properly stored with withdrawals made as agreed by both parties. Material purchases should be supported by invoices and should be limited to the quantities and types specified in the partnership contract;
- (iv) Sales revenues should be deposited in the venture account regularly;
- (v) The partner is required to submit periodic reports showing the details of the operations;
- (vi) The client should adhere to the dates set for the commencement and liquidation of the venture project

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- (vii) And above all, both field follow-up and office follow-up should be used. To elaborate, visits to the projects should be made to check materials, documents, performance and management. In addition to that office checking, follow-up should be carried out which includes checking documents and reports, meetings with clients, and training clients to improve management skills.

The primary reasons for monitoring, therefore, are:

- (i) To keep track of project progress;
- (ii) To provide feedback on the project management;
- (iii) To serve as a warning mechanism for project management; and
- (iv) To help prevent or solve problems encountered during project implementation

(Al-Harran, 1995b)

Project failures on the part of the bank to follow-up the operations closely may be because of distance, the lack of marketing outlets and the inexperience of the staff (El-Bhasri and Adam, 1997). For example, in financing small businesses, the close proximity of the business location to the bank's branch has been found to be helpful. This enables close supervision by the bank representatives, and easier contact on the part of the partner. It also facilitates the regular deposit of sales proceeds.

The Grameen bank experience sheds light on the success of using group lending methods, which, by analogy, might be used in financing *musharakah* only to small and micro businesses (Abdalla, 1999). To elaborate, *musharakah* agreements should be concluded with members of a group of five clients, for example, instead of on an individual basis. Those members of each group mutually select each other before applying to the bank. Then, group collateral would be taken by the bank, which means if a fraud or misuse of funds has been proved against any member, then the whole group will be responsible. Additionally, monitoring of *musharakah* could be undertaken by the group leader

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in collaboration with the bank staff (Abdalla, 1999). This will reduce the administrative burden on bank staff and at the same time provide alternative security against possible fraud or misuse.

3.8 Marketing the Product of the Entrepreneurship

In *Musharakah* the bank may take an active role in marketing partnership products, thus reducing the marketing burden of the entrepreneurs. The goal here is to help partners fetch good prices for their products which are often low at the production time or facing high competition. Marketing involves providing channels whereby products are distributed from producers to consumers. In agricultural projects, for example, the price which a crop fetches at harvest time is usually lowest in the area of production. Thus, the problem is related to storage and transportation. Storage is still difficult though it is receiving a good degree of consideration.

Another way to carry out the role of marketing is to establish a subsidiary company to play the role for all similar products created by different partnerships and entrepreneurship projects. The marketing subsidiary company will take over the function of middlemen in the traditional marketing system, while giving better prices for their catches, and at the same time promoting the partnership goods in the marketing activities so as to encourage their self-reliance. The main aim is to promote and to reduce wastage to meet the demand of consumers. The marketing subsidiary will be able to offer higher prices to the customers and partnership because it sells productions directly to its retailers and wholesalers without going through the various middlemen, and with all the mark-up going to the company. The marketing subsidiary will also be responsible for promoting new channels for marketing (Al-Harran, 1995b).

Primarily, the marketing subsidiary companies objectives are:

- (i) To collect and distribute the goods to various places within the state or outside the state or to export markets;

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- (ii) To provide the direct link between the producer and the consumer, by reducing the role of the middleman;
- (iii) To provide up-to-date information on market prices for goods under sale, so that the price will not be easily manipulated by the middleman;
- (iv) To encourage the customer to be involved in distribution activities as partners or shareholders of the marketing subsidiary.

(Al-Harran, 1995a)

The marketing subsidiary will provide transportation to the various markets, suitable storing like refrigeration facilities, warehousing and so on. Taking part in the marketing mission, this would no doubt broaden the bank's scope of knowledge and develop its business skills, this being another asset to the bank. This business skill is transferred to entrepreneurs in the process of *musharakah* financing and adds to the merits of this method of financing from the entrepreneur's perspective (Abdalla, 1999). As a result a proper follow-up, good performance, high profitability and low risk can be favourable gains for increasing the profitability of the banks and its share holders as well as the whole community (Al-Harran, 1997).

3.9 Securitization of *Musharakah*

Musharakah can be securitized, especially in the case of big projects where huge amounts are required to which only a limited number of people can afford to subscribe. Every subscriber can be given a *musharakah* certificate which represents his proportionate ownership in the assets of *musharakah*, and after the project by acquiring substantial non-liquid assets, these *musharakah* certificates, can be treated as negotiable instruments and can be bought and sold in the secondary market. This represents the difference between bonds and *musharakah* certificates as the bond stands as a loan associated with interest and has nothing to do with the actual business and its outcome while the *musharakah* certificate on the contrary, represents the direct pro-rata ownership of the holder in the assets of the projects. If all the assets of the joint projects are in liquid form, the

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certificate will represent a certain proportion of money owned by the project, so, if sold it will mean unequal money exchanged for money which is not allowed in *shari'ah*. In contrast, when the capital provided is used for buying assets like machinery, raw material, furniture etc., the *musharakah* certificate will represent the holders' proportionate ownership in these assets (Usmani, 1999). However, trading in these certificates is not allowed when all the assets of the *musharakah* are still in liquid form like cash or advance due from others. For a valid trading of the *musharakah* certificates acceptable to all schools except the *Hanafites* it is necessary that the portfolio of *musharakah* consists of non-liquid assets valued at more than 50% of its total worth. For the *Hanafites* School trading is allowed even if the non-liquid assets are less than 50%, but the size of the non-liquid assets should not be negligible (Usmani, 2002).

3.10 Musharakah and Inflation

In countries with high inflation, *musharakah* preserves the real value of capital invested that is, at the time of selling the two partners may decide to delay selling in anticipation of higher prices (Ibrahim and Vijaykumar, 2003). The sale of goods of the joint project can be postponed until the price rises to a level at which it is profitable to sell the products. It has thus an in-built indexation which hedges against inflation. *Musharakah* neutralizes the effect of inflation because it boosts the prices and augments profits which banks share with clients. The settlement of projects financed is always based on current market prices and not on the prices which existed at the time of writing the contract. The amount of money recovered by each partner is based on a proportion of the profits actually earned. Thus, it is automatically adjusted for the inflation (Akhtar, 1997).

Compared with *murabahah*, the fixed nature of the mark-up during the contract period, which at times may stretch to a number of years, poses a severe problem and undermines the bank's profit performance. This in turn could prevent banks from raising the rate of return paid to their investment-deposit holders, who stand to lose the purchasing power of their deposits due to prolonged inflation (Najmabadi, 1999).

3.11 Economic Risks

Compared with the non-PLS mode of finance, PLS modes are more risky, PLS can not systematically be made dependent on collateral or other guarantees and the administration of PLS modes is more complex compared with non-PLS. These activities include the determination of profit and loss sharing ratios on investment projects in various sectors of the economy, and the ongoing auditing of financed projects to ensure that Islamic banks' shares are fairly calculated. Therefore, in order to safeguard funds and realize profits, Islamic banks would need to rely on a set of appropriate policies and adequate infrastructure for portfolio diversification, monitoring and control in PLS modes rather than non-PLS modes. Risk of loss, dishonesty, revealing the business secrecy, and unwillingness to share the entrepreneurship profit are the main concern in financing through the *musharakah* scheme.

3.11.1 Concerns about PLS and *Musharakah* Finance Scheme

Financing entrepreneurs through *musharakah* is more likely to pass on losses of the business to the banks and consequently this loss will be passed on to depositors. Hence, the depositors, having being constantly exposed to the risk of loss, will not be willing to deposit their money in these banks. As a result their savings will either remain idle or will be used in transactions outside of the industry of banking channels. In the final stage, this will lead to these savings not contributing to the economic development at the national level (Usmani, 2002). It important to study, with more depth and precaution, the risks, guarantee if needed, and the potentials of the business if relevant. Since these projects will be feasible studies, then risk management can be developed to minimise the exposed risks and to maximise the expected profitability. Therefore, it is more likely that over time through accumulated experiences, these banks will be able to develop their own approaches and accept only those projects which fulfil the need of achieving higher profitability (Usmani, 2002).

3.11.2 Dishonesty

In financing entrepreneurs through *musharakah*, some dishonest clients may take advantage of the *musharakah* instrument by not sharing any return with the bank by hiding the real earning of the entrepreneurship and claiming that it has suffered a loss or revealing an underestimated profit achieved, in which case the bank will jeopardise not only the profit but also the capital (Usmani, 1999). Compared with Islamic banks, in conventional banks, the defaulters have always created the problem of bad debts. However, undoubtedly, the apprehension of dishonesty is more severe for Islamic banks. To overcome the problem the following proposals can be suggested.

First of all, a well designed system of auditing should be implemented whereby the accounts of all the entrepreneurs are fully maintained and properly controlled.

Secondly, credit scores should be applied to measure entrepreneurs' risks. It is worth mentioning here that there is an urgent need for a data system about entrepreneurs' history and work thought credit scores to measure the risk brought from the entrepreneur. If any misconduct, dishonesty or negligence is established against a client in any bank, he might be subject to punitive steps, and may be deprived of availing any facility from any bank in the whole country, at least for a specified period. However such an approach is yet to be implemented in Sudan.

Thirdly, banks might agree to finance a high risk *musharakah* on a selective basis to a number of clients, considered to have integrity beyond all reasonable doubt. Lastly, there are some sectors where there is not much room for misconduct, negligence and dishonesty to be an obstacle for financing through *musharakah* such as Import and Export. Almost every essential thing will be known e.g. the exporter will have the specific order from abroad, the prices will be agreed, the costs will not be difficult to determine, payments will normally be secured by a letter of credit, and the payments are made through the bank itself. Similarly, financing of imports may be designed on the basis of *musharakah* with some precautions, as explained earlier. Therefore dishonesty will not be an obstacle against using *musharakah* instruments (Usmani, 2002).

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These steps will serve as strong prevention against hiding the actual profit or committing any other act of dishonesty. Otherwise, the clients of the banks cannot afford to show artificial losses constantly, because it will be against their own interest in many respects. It is true that even after taking all such precautions, there will remain a possibility in some cases where dishonest clients may succeed, but penalizing steps and the general atmosphere of the business will gradually reduce the number of such cases.

3.11.3 Secrecy of the Business

Another assertion is that, by making the bank a partner in the business of the client, it may disclose the secrets of the business to other traders through the bank. This obstacle in many cases is almost theoretical as banks do not usually interfere deeply with management affairs, which causes another problem for *musharakah* projects. However, a suggestion can be made to include a condition in the contract which prohibits the bank either from interference with management affairs or disclosure of any information about the business to any person without prior permission of the entrepreneur (Usmani, 1999).

3.11.4 Entrepreneur's Unwillingness to Share Profits

It is argued that some entrepreneurs are not willing to share with the banks the actual profits of their business. Their reluctance is based on two reasons. Firstly, they think that the bank has no right to a share of the actual profit, which may be substantial, because the bank has nothing to do with the management or running of the business, as well as any creativity that might be involved in the business, so why should they (the entrepreneurs) share the fruits of their labours with the bank who merely provides the funds? To overcome this concern, fair and proper measures should be taken to estimate the management's role in the profit, and this should be reflected on the management's share of profit denoted to the entrepreneur.

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Secondly, it is further contended that information about the real profit might be passed through their banks to tax authorities, and so the entrepreneurs' tax liability increases accordingly (Usmani, 1999). In fact, many countries charge unreasonable tax, regardless of the kind of finance the entrepreneur has succeeded to secure. In this regard, a recommendation to change tax policies and laws should be passed down to the parliaments of these countries for a fair tax system. In addition, before entering into a partnership agreement, banks are required to review the purpose, prospects, and future operations under the proposed partnership agreement, and ensure that the expected profit will be realised and visible to cover estimated tax, and that the partnership capital will be, in all probability, safe and secure throughout the duration of the agreement, and that the partnership agreement can be terminated at the end of its duration accordingly (Usmani, 2002).

3.12 Conclusion

A *musharakah* contract covers both finance and management terms to which both parties must adhere. In addition, the contract should provide the percentages of profit and loss distribution after deducting all agreed upon costs including insurance cost. The contract will also determine the possibility of the joint storage of raw materials. In order to carry out transactions, a joint account will be opened in the name of the partnership in which both withdrawals and deposits from sales are made according to the contractual terms (Ibrahim, 1999). In case of financial loss, these unfavourable returns will be distributed to both parties according to the capital share unless it has been proved that it is a natural and direct cause of neglect, abuse or violation of terms agreed upon by the party undertaking the management and operation of the venture, in which case such party shall bear the cost of all damages (Ibrahim and Vijaykumar, 2003). The *musharakah* scheme puts great emphasis on the transaction itself, rather than the creditworthiness of the partner. No strict security should be demanded unless it is against possible fraud or repayment-evasion, not against the risk of losses. Any advancement demanded is made to cover the share of the partner in the venture and not as a security against losses (Thomas, 1995).

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In a sense, however, *musharakah* partnerships require no more of the banker, or his customer, than is required in a genuine business-based relationship, as opposed to one based mainly on security. If the bank genuinely bases its decision on an appraisal of the entrepreneur and the earning capacity of his proposed investment, and monitors the account on a regular basis in order to forestall problems, he will need to be as familiar with the business as a banker who has invested in a *musharakah* partnership (Ibrahim and Vijaykumar, 2003).

The scheme has many advantages, although its application is not without constraints and its theory raises some concerns which can be overcome if the method followed some recommendations.

The following concluding remarks may be obtained from this chapter:

- (i) *Musharakah* finance through Islamic banks is a contractual agreement between the bank and the customer (partner or entrepreneur), using both human and financial resources to distribute whatever profit and loss they make in accordance with capital and human resources invested (Thomas, 1995).
- (ii) The unique feature of *musharakah* is that the bank shares profits as well as losses with the customers, and hence he or she shares in the business risk.
- (iii) It is a suitable mode of financing for both working and fixed capital. The customer does not have to contribute in cash to the proposed investment. His or her share might be in kind (inputs), labour, and/or rent of machines or equipment. Also, he or she is rewarded for his/her entrepreneurship, since in relatively profitable ventures the return on investment is much higher than other modes of finance (Abdalla, 1997). Another important advantage of *Musharakah* is that the customer does not have to contribute a large share of money.
- (iv) As *musharakah* finance puts great emphasis on the transaction itself, rather than the creditworthiness of the partner, no strict security should be demanded. Islamic financing does not require the partner to

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present securities against possible losses. Any advancement demanded is made to cover the share of the partner in the venture and not as a security against losses. However, banks may demand security against possible fraud or repayment-evasion, mismanagement, and not against the risk of losses (Ibrahim and Vijaykumar, 2003).

- (v) *Musharakah* finance needs personal acquaintance with the client and his behaviour, in addition to continual supervision and follow-up by the bank's management, which are necessary requirements in the absence of conventional guarantees. In other words, it creates incentives for the capital provider to monitor and assist his partner.
- (vi) *Musharakah* is also a flexible, easily understandable form of financing.
- (vii) *Musharakah* achieves the risk diversification objective by distributing *musharakah* fund among different customers, different amounts, different type of projects, etc...
- (viii) Both the bank and the customer (the two partners) have the right to withdraw under certain conditions if it causes no injury to either partner, if communicated to other parties (Ibrahim, 2004).
- (ix) It seems that the *musharakah* mode of finance can also be modified to be used to supplement the Western lending method.
- (x) *Musharakah* links the use of funds directly to social and economic priorities, and it directly rewards and provides more incentives to human labour, thereby drawing non-bankable classes into the productive circle of the economy (Al-Harran, 1995b).
- (xi) *Musharakah* system protects both parties against inflation. It also avoids the necessity of demanding repayment from people who have already lost their livelihood.

The research so far presented a discussion on *musharakah* from both *fiqh* and economics perspectives. The next chapter covers broadly the Sudanese economy and monetary policy with the objectives of providing a policy framework within which *musharakah* and in particular Islamic finance operates.. Hence, it discusses the performance of the Sudanese economy and demonstrates the

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important characteristics of the credit and monetary policy of the Central Bank of Sudan. In addition, the further chapter (Chapter Five) focuses on the Sudanese banking industry by providing an overview of the historical developments in the Sudanese banking industry and its performance using some selected banking and financial indicators. Both chapters aim at locating the *musharakah* financing in a larger macro-economy context, which further aims to build a strong foundation for the empirical analysis.

Chapter 4 Sudan: Economy and Monetary Policy: an Overview

4.1 Introduction

Sudan, the largest country in Africa and the Middle East, is located in the north eastern part of the African continent. The country encompasses an area of about 250.6 million hectares (1 million square miles), bounded on the north east by the Red Sea and on the other sides by nine African nations. It borders Egypt to the north; Eritrea and Ethiopia to the east and southeast; it also shares its southern border with Kenya and Uganda, its south-western border with the Central African Republic and the Democratic Republic of the Congo; its western border with Chad and its north-western border with Libya. The Sudan lies within the tropical zone between latitudes 3° and 22° north and longitudes 22° to 38° east (CSS, 2001). The total area of the country is 2,505,813 square kilometres. The country is divided administratively into 26 States (Country Studies, 2006).

The total population in 2005 was just over 36 million of which 51% are male and 49% are female with an annual population growth rate of 2%. 15% of the population live in the capital Khartoum. The number of births per 1,000 populations is 38; the number of deaths is 10. The infant mortality rate per 1,000 live births is estimated at 125. The average number of lifetime births per female is 5.7. The crude birth and death rate are 37.8% and 11.5% respectively (WB, 2006a).

The Legal system in Sudan is based on both *shari'ah* law and English common law as of 20 January 1991 when the government imposed *shari'ah* law in the Sudan and after 2005 the *shari'ah* has only been observed in the northern states; according to the peace agreement, *shari'ah* law applies to all residents of the northern states regardless of their religion; the southern legal system is still developing following the civil war (Ahmed, 2005).

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Macroeconomic performance has been quite poor in Sudan in the nineties. Economic indicators have nearly stagnated after 1999. Sudanese economic growth is one of the concerns as it might influence the banking performance. However, the economic performance has not been the same since 1990 as it witnessed an improvement after 1999.

As far as the credit policy is concerned the central Bank of Sudan started issuing annual financing (credit) policies since the early 1990s. To suit the purpose of the Islamic profit and loss sharing system, the credit policy was changed to a financing policy. The Islamic system does not provide credit, but finance production. Moreover, the basic functioning of the Central Bank in which there is full Islamization of the banking system is the same as a conventional bank, but the mechanism is different. The policy is designed to support government plans, the objectives of which are usually achieving self-sufficiency, increasing production, reducing inflation, and stabilising exchange rates, thereby promoting the image of Islamic banks as comprehensive, full service banks (Ibrahim and Vijaykumar, 2003).

To get an overall idea of the economic environment in which the banking system works in Sudan, this chapter discusses major characteristics of the Sudanese economic activities and identifies empirically, through the common economic indicators, the performance of both the Sudanese economy and the credit policy. This chapter examines the obstacles facing the economy and the limitations set by the credit policy for the banking sector. It should be noted that the bank's finance through *musharakah* is more likely to be correlated with country economic performance.

The rest of the chapter will be as follows: the second section discusses the Sudanese economy performance; the third section demonstrates the important characteristics of the credit and monetary policy of the central bank of Sudan. The last section is devoted to conclusions.

4.2 Economic Performance

4.2.1 Economic Resources

4.2.1.1 Water and Land Use

Sudan extends from the hot arid north to the tropics in the south with diversified ecosystems that provide immense fertile land of about 80 million hectares, natural pastures of about 24 million hectares, and a forest area of about 64 million hectares. Over 40% of the total area of Sudan consists of pasture and forests and the remaining land is desert or semi-desert (Country Studies, 2006). Arable land constitutes about one third of the total area of the country, however only 21% of this arable land is actually cultivated. Natural pasture provides grazing land for nearly all livestock. The annual production of animal feed is estimated at 78 million tons of dry matter. Production is subject to fluctuations from one year to another, affected by varying quantities of rainfall and fire hazards. Forests are exposed to continuous removal and clearance either for agricultural expansion or for fire wood consumption (MFNE, 2002).

As Sudan is a country with an enormous national resource base and a huge agricultural potential, it goes without saying that all efforts to produce more human food from agriculture should be effectively undertaken.¹ The Sudan is also gifted with plenty of irrigation water from the River Nile and its tributaries, rains, as well as underground water reserves. About 75% of the population of Sudan predominantly subsist on agriculture (The World Bank, 2006).

4.2.1.2 Primary Economic Resources

Although the country has been trying to diversify its cash crops, cotton and gum Arabic remain its major agricultural exports. Grain sorghum (dura) is the principal food crop, and wheat is grown for domestic consumption. Sesame seeds and peanuts are cultivated for domestic consumption and increasingly for export.

¹ One feddan 1.038 acres or 0.42 hectares.

The available resources in terms of arable land, water and livestock suggest that agriculture in Sudan provides the best opportunities for future economic growth and development. Yet, the country's agriculture is largely traditional and is characterized by low and fluctuating productivity, which means that modernization and development are imperative (Elhiraika and Ahmed, 1998). Sudan remains a net importer of food. Problems of irrigation and transportation remain the greatest constraints to a more dynamic agricultural economy. Livestock production has vast potential, and many animals, particularly camels and sheep, are exported to Egypt, Saudi Arabia, and other Arab countries. Fishery resources are around 300,000 tonnes per year, but only 60,000 are exploited at the present time. Sudan is rich in mineral resources such as gold, chrome and cement (Ibrahim, 2004).

4.2.2 Other Resources

Oil production and export are taking on greater importance since October 2000. In addition to its natural, agricultural and animal resources, Sudan abounds with potential mineral wealth of which petroleum, now exploited, is the most important with prospects for additional reserves. Gold mining and exports are on a rising trend while numerous minerals such as iron ore, copper, mica, zinc, chromate and manganese together with non-ferrous resources such as plaster, lime and black sand are also available in appreciable quantities and potentially tradable (Osman, 1999). This could pose a real base for industrial development.

4.2.3 Current Political Situation

The political situation in Sudan is complex. Since independence from the UK in 1956, Sudan had three democratic elected governments and four military coupes. Sudan was embroiled in two prolonged civil wars during most of the remainder of the 20th century. The first civil war ended in 1972, but broke out again in 1983 and continued for over a period of two decades. After a 1989 military coup, the circle of Islamic National Islamic front party ruled. Peace talks gained momentum in 2002-2004 with the signing of several accords. On July 9, 2005, pursuant to a January 2005 final peace agreement that ended the decades-long

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civil war between the government in Khartoum and the Sudanese People's Liberation Army\Movement SPLA\SPLM that had cost millions of lives, a government of national unity was established under an interim constitution.

These protocols signed as part of the peace agreement include Machakos protocol of July 20th 2002; Security Arrangements Agreement of September 25th 2003 and Framework Agreement on Wealth Sharing of January 7th 2004. Under the January agreement, which included compromises on political representation, self-determination, and distribution of oil resources, the leader of the main southern rebel group, was named vice president as well as the president of the southern Sudan government. The agreement granted the southern rebels autonomy for six years, after which a referendum for independence is scheduled to be held.² The wealth-sharing agreement signed as part of the peace agreement establishes a framework for sharing and managing oil resources, delineates taxation powers between the national and southern governments, allows conventional banking in south Sudan, provides for the introduction of a new national currency, establishes a process to address land claim issues, and organizes the relations of the national and southern governments with external donors. The agreement establishes a national petroleum commission responsible for managing the oil sector, confirms the principle of saving part of the oil revenue, provides 2% of net oil revenues to oil producing states, and divides the remaining net oil revenues (from oil produced in the south) equally between the national and southern governments. The wealth sharing agreement institutes the right to have a dual banking system in Sudan during the Interim Period. An Islamic banking system shall operate in Northern Sudan and conventional banking system shall operate in Southern Sudan. In addition, the right to establish, during the Pre-Interim period, the Bank of Southern Sudan (BOSS), as a branch of the Central Bank of Sudan (BOS), which will provide conventional banking facilities urgently.

In Darfur, the western region, a civil war started in 2003 mainly between the Arab Janjaweed militia and African militias. The situation has been labelled the

² For the full context of the Peace agreement see www.gurtong.org.

worst humanitarian crisis in the world today. It has left about 200,000 people dead. An estimated 2 million civilians have been displaced from their homes.

Sudan has also faced large refugee influxes from most of its neighbouring countries, primarily Ethiopia, Eritrea, Uganda, and Chad, and armed conflict, poor transport infrastructure, and lack of government support have chronically obstructed the provision of humanitarian assistance to affected populations (CIA, 2004).

Sudan's economy, therefore, faces instability, conflict-damaged infrastructure and mismanagement.

4.2.4 Economic Performance: 1990-2006

In 1989 in an attempt to reverse the economic decline, stimulate economic growth and the heavy dependence on commodity aid and external foreign assistance which has taken place before, the government embarked on a medium-term three-year economic programme referred to as the national economic salvation programme 1990-1993. With economic liberalization as an overall objective, the programme sought to reallocate resources to enhance production particularly in agriculture in order to achieve food security and to generate export surplus; to boost the role of the private sector; to remove price and exchange rate controls; to privatize public entities; and to achieve financial stability. By 1992 several price and exchange rate controls were removed (Elhiraika and Ahmed, 1998). However, these three years together with the following two years, in which the full adoption of Islamic modes of finance in 1990 took place, were the most dramatic years in the recent economic history of Sudan. Financial institutions were among the vital state institutions the government attempted to transform into partisan sources rather than national institutions through its corporatist policies. Moreover, the government attempted to create a new class of entrepreneurs by massive redistribution of wealth to government-party loyalists through fiscal and monetary policy, including a heavy inflation tax (Elhiraika, 2004). This, together with efforts for general economic development and winning the war militarily led to uncontrollable government spending, massive domestic

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borrowing, three digit inflation rates, exchange rate collapse, and financial disintermediation due to macroeconomic instability and loss of public confidence in the financial sector.

The principal causes of the disorder have been the violent, costly civil war, an inept government, an influx of refugees from neighbouring countries, as well as internal migration, and a decade of below normal annual rainfall with the concomitant failure of staple food and cash crops. During the nineties half of the Sudanese budget, more than \$1million a day, was spent on the continuing civil war.

The relation with IMF was not an exception to the bad situation. After becoming the world's largest debtor to the World Bank and International Monetary Fund, the IMF took the unusual step of declaring Sudan non-cooperative because of its non-payment of arrears to the Fund. After Sudan backtracked on promised reforms in 1992–1993, the IMF threatened to expel Sudan from the Fund. In 1993, the IMF suspended Sudan's voting rights and the World Bank suspended Sudan's right to make withdrawals under effective and fully disbursed loans and credits. Lome Funds and EU agricultural credits, totalling more than one billion Euros, were also suspended. To avoid expulsion, Khartoum agreed to make token payments on its arrears to the Fund, liberalize exchange rates, and reduce subsidies, measures it has partially implemented. The relation with the IMF was restored in the late 90s (Kireyev, 2001).

Later, the relation with both International Monetary Fund (IMF) and the World Bank considerably improved; hence IMF issued many certificates assuring the progress of Sudan's economic performance for increase of growth rates, a declining inflation rate and stabilization of exchange rates which in turn encouraged Arab and regional investment funds to enhance their relations with Sudan and financing developmental projects.

Sudan has turned around a struggling economy with feasible economic policies and infrastructure investments, but it still faces formidable economic problems, starting from its low level of per capita output. From 1997 to date, Sudan has

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been implementing IMF macroeconomic reforms. The government has formulated a medium-term reform programme covering 1998–2003 which aims at achieving an average real GDP growth of 6% a year, reducing inflation to 5% by the end of the plan, and improving Sudan's external accounts, by addressing long-standing structural rigidities, mobilizing private savings, and encouraging foreign direct investment (IMF, 2005).

There have been, however, aggravating factors; the International unpopularity of the military government caused a drying up of transfers (aid and concessionary loans) from abroad, which led to an increase in the inflationary pressures in the economy, since the government compensated from the Central Bank (Stiansen, 2004). In 1999, Sudan began exporting crude oil and in the last quarter of 1999 recorded its first trade surplus, which, along with monetary policy, has stabilized the exchange rate.

4.2.5 Selected Macroeconomic and Financial Indicators of Sudan

Table 4.1 depicts the performance of the macroeconomic indicators over the entire period considered.

Table 4.1 Selected Macroeconomic Indicators of Sudan, 1990-2006

	GDP, current prices Billions U.S. dollars	GDP per capita, current prices Billions U.S. dollars	GDP growth rate	Agriculture GDP share	Industry & Mining GDP share	Services GDP share	Exchange rate SD ³	Inflation, annual percent change	Inflation consumer prices 2000=100
1990	24.45	949.299	-5.4	30.3	15.4	54.4	0.45	65.2	0.562
1991	27.52	1,037.42	7.5	28.7	17.6	53.9	0.69	123.6	1.256
1992	3.38	123.579	6.5	33.7	17.1	49.1	9.7	117.6	2.733
1993	5.73	203.446	4.5	37.9	17.4	44.5	16.1	101.3	5.501
1994	4.37	150.884	1	40.1	16.4	43.5	29.6	115.5	11.853
1995	7.32	261.9	5.9	43.1	15.8	41.1	55.9	68.4	19.958
1996	8.765	306.807	5.9	44.9	14.5	40.6	125	132.8	46.467
1997	11.68	400.119	6.3	47.6	15.1	37.2	156.9	46.7	68.144
1998	11.32	380.217	6.4	48.6	15	36.2	198.8	17.1	79.8
1999	10.72	352.483	6.7	49.8	15.8	34.4	252.1	16.0	92.564
2000	12.37	414.947	5.8	46.4	21.4	32.2	257.2	8.0	100
2001	13.38	440.137	6.2	45.6	22.8	31.6	257.3	4.9	104.871
2002	15.12	486.021	6.4	46.0	23.1	30.9	263.3	8.3	113.611
2003	17.58	551.155	4.9	45.6	24.1	30.2	260.8	7.7	122.371
2004	21.48	656.871	5.2	44.5	25.4	30.1	258.2	8.4	132.673
2005	27.54	819.697	7.9	38.6	27.8	33.6	243.5	8.5	143.972
2006 ⁴	37.571	1,089.86	12.1	-	-	-	222.8	7.5	154.086

Source: Ministry of Finance and National Economy, Bank of Sudan and the IMF

4.2.5.1 GDP Growth

Generally, if the researcher divides the period into five-year sub-periods starting 1990, the GDP has increased massively in 2005 compared with 1990, 1995, and 2000 as shown by table 4.1. The only possible explanation of the GDP growth decrease in 1994 is in terms of rainfall as the economy is dominated by agriculture and agricultural output is largely rain-driven. Current GDP per capita of Sudan decreased 5.4% in 1990 then grew 5.9%, 6.7% and 12.1% in 1995, 2000 and 2005 respectively (MFNE, 2006). In 2005, the Sudanese economy is considered the fifth fastest growing economy over the world (MW, 2006).

³ The currency for the period before 1999 is Sudanese pounds SP and after is Sudanese Dinar SD where 1 SDD equals 10 Sudanese pounds SP.

⁴ The GDP for 2006 estimated by the International Monetary Fund.

It is possible to conclude that there has been a positive growth of the GDP because of increased contributions from various sectors especially the contribution of the Oil sector. The performance of Sudan's economy at a macro level has been impressive: GDP growth since 1990 averaged 5.5%.

4.2.5.2 Contribution of Different Sectors to the GDP

As a result of dependence on agriculture, GDP growth figures have fluctuated wildly and there were a series of recessions in the 1980s and 1990s (Hussein, 2003). Since 1993, however, growth has been steady, at 3-6% a year in real terms. Agriculture remains the dominant sector but the emergence of the oil sector has begun to shift the balance. As table 4.1 shows the share of agriculture in the GDP fluctuated between 28.7% and 49% in 1990 and 2006. This wide fluctuation indicates erratic changes in agriculture production due mainly to weather conditions, the civil war that displaced millions of rural families, lack of investment in agriculture, and so on. The general upward trend in the contribution of agriculture to GDP reflects intensified government effort aimed at achieving food security during that period. In the period 1990-1999, the trend of real GDP was very much related to that of real agricultural GDP (Elhiraika, 2003).

Agriculture, before exporting oil, which accounts for an average (1990-2001) contribution of 41% of GDP, has recorded an average (1990-2001) growth rate of 8%. Cultivable area has expanded from 7.7 million hectares in 1989 to around 17 million hectares in 2001 (MFNE, 2006). Animal wealth has also recorded an increasing number of heads from 60 million in 1989 to around 128 million in 2001, and its contribution to GDP has risen to more than 20% since mid 1990s. These developments have been associated with strong macroeconomic policies and favourable climatic conditions. Henceforth, food security has improved and a strategic grain food reserve was built to safeguard for seasons of uneven rains in addition to stabilize prices. It is clear from Table 4.1 that the rate of growth of the GDP has declined from 6.4% in 2002 to 4.9% in 2003 basically due to a decrease in growth of the agricultural sector. The growth rate of the agricultural sector in

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its two parts, the agrarian and animal, has noticeably decreased from 7.3% in 2002 to 5.2% in 2003 mainly due to deterioration in the traditional rain-fed agriculture.

The economy before 2001 depended heavily on agriculture for employment, production and consumption. The share of agriculture in Sudan's gross domestic product and exports during the period 1990, 1995, 2000, 2005 was around 30%, 43%, 46% and 38% respectively (Elhiraika and Ahmed, 1998).

The industrial sector still depends on agricultural raw material inputs such as vegetable oil, sugar cane, cotton, hides, skins etc... With more development of these natural resources agro-industrial potential investment opportunities will thrive and encourage manufacturing of agricultural-related means of production required for improving productivities of both plant and animal sectors (WB, 2005). The industrial sector share of GDP has attained 15.3% during the period 1990 – 2001. Its output growth is mainly ascribed to intermediary industries, mining and quarries whereas petroleum production and petroleum exports have started to influence a change in production structure and output. After 2000, for example, the value of the manufacturing and mining sector grew by 30% in nominal terms (a 12% real rise) lifting its share of GDP to almost 7%, compared with 15% in 1995.

The contribution of the industrial sector to the country's GDP remained small, around 15% in 1990 and 1995 then over 20% after 2000. Sudan got a significant boost when its oil exports began in 1998, turning a \$300 million annual bill for petroleum products into a source of revenue that could earn \$1.2 billion (Hussein, 2003).

The contribution of the services sector to the country's GDP was more than half in the early nineties then decreased to 40% in the mid nineties then to 30% in the new millennium compared with 54% in the 1980s. This is mainly due to macroeconomic policy bias favouring the real productive sectors (MFNE, 2006).

4.2.5.3 Inflation

As table 4.1 shows inflation has been reduced from 132% in 1996 to less than 8 percent in 2006. The Government's strong economic reform package contributed to high economic growth starting in the late 1990s. The start-up of oil production and favourable weather conditions for agricultural production also helped to sustain growth. Higher growths, together with economic reforms, have increased the government's budget revenues. However, widespread poverty, highly skewed income distribution, and inadequate delivery of social services remain serious problems (WB, 2006b). The monetization of the government's budget deficit created severe inflationary pressures in the past and price rises averaged over 56% a year in 1995-1999. In 1996 money supply growth reached 88%. This fell to 28% in 1999, and the fall was reflected in the sharp downward trend in inflation. Annual price increases fell from 133% in 1996 to 46% in 1997, when the structural adjustment process began, and to under 20% in 1998-1999 (Elhiraika, 2004). The trend continued into 2000 with inflation falling to 10%. Sudan has benefited from lower import costs over the recent years, as average international non-oil commodity and manufactured goods and prices have fallen.

The Sudan economy has been transformed from an economy with very high rates of inflation in the mid-1990s to a more stable economy where the inflation rate is at a single digit level after 2000 as seen from table 4.1. The estimated rate of inflation for 2006 is 8.3%.

4.2.5.4 Exchange Rate

The Sudanese exchange rate policy in 1990s is characterised by inconsistency in objectives, confusion, loss of control over foreign exchange and payments. Also the remittance of Sudanese working abroad that tended to play a major role in shaping exchange rate policy. In the early 1990s dealing in hard currency was not allowed outside the banking industry (IMF, 2005). Later in the second half of the 1990s, the authority allowed only exchange currency agencies to buy and sell hard currency then developed to the full demand and supply mechanism of

deciding the price of these currencies, in which the government was able to stabilise the exchange rate value in the late 1990s. Furthermore in 2000s, the currency is no longer volatile but very stable and determined by the market.

Since 1980, for more than 15 years, the exchange rate increased but improved later. During the period 1990-1995, the exchange rate deteriorated seven times. Since late 2004, improved market fundamentals coupled with a move towards a market-driven exchange rate have led to an appreciation of the dinar. In 2005, the economy grew at a fast pace and higher oil prices led to a 35% increase in oil exports. In addition, foreign direct investment rose sharply from US\$1.8 billion in 2003 to US\$3.8 billion in 2005. During the last year, the currency appreciated by 12% and 17% in nominal and real effective terms, respectively (IMF, 2006). The current exchange rate is over LS 2600 per dollar, up from only LS 18 in the late 90s (IMF, 2006).

4.3 Monetary and Credit Policy

4.3.1 Introduction

Monetary and financial policy has, since the early 1980s, been increasingly used in developing countries including Sudan to meet the challenges of both short term stabilization and long term adjustment. In Sudan, however, monetary policy has consistently been used to simultaneously attain both stabilization and growth objectives. Yet these objectives may not become complementary. For instance, while stabilization requires containment of bank credit, growth requires increased mobilization and efficient utilization of financial savings (Elhiraika, 1998).

The main aims of the Bank of Sudan (BOS), as mentioned in its establishment law, are to regulate issuance of currency and coins, to help regulate the banking system, the monetary and credit systems in the Sudan, and to work to ensure financial stability, to achieve economic development in the country in a systematic and a balanced fashion, to consolidate external currency stability, to be the bank of the government and its advisor in financial affairs and to manage

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credit by determining general and sector credit ceilings (BOS, 1990-2006; BOS, 1990-2005).

In Sudan, credit policy has, since the early 1980s, been progressively restrictive concerning the size and sectoral allocation of credit. Quantitative credit control consisted of a direct ceiling on bank lending to the private sector, with the hope of curtailing money growth and inflation. Meanwhile, selective credit control was implemented to enhance economic growth by means of channeling credit to perceivably more productive sectors and related activities. The priority sectors encompassed agriculture, manufacturing, export and transport for which medium and long terms loans were particularly encouraged to finance working as well as fixed capital. In the late 1970s and as part of a stabilization programme inspired by the International Monetary Fund, commercial banks were directed to extend at least 10% of their total advances in the forms of development loans. As from 1986 onwards, this policy was further tightened to limit commercial banks' advances under the ceiling. To reduce the risk inherent in agricultural credit in particular, consortium financing was encouraged (Elhiraika and Ahmed, 1998).

It is possible to conclude, therefore, since BOS establishment in 1960 up to 1984, the year in which the Islamic laws were introduced, the BOS continued to use both direct and indirect financial policy instruments that facilitate it to supervise the credit policy as it used to control the quantity of money through interest rates, changing the ratios of monetary reserves, directives by way of determining maximum levels of financing (credit ceilings), and through other supervisory measures. The bank also carries out its administrative and banking control roles according to its laws, which were amended several times to cope with the financial and economic policies of the country the last of which was in 1993 (BOS, 1990-2006).

The objectives of a central bank in an Islamic economy do not differ fundamentally from those of a conventional bank. Ensuring the stability of the currency has been noted in the history of Islamic scholarship on economic matters. However, the real difference between the two types of central banks is in

the instruments that each can employ to achieve their common objectives (Khan, 2002).

After the Islamization of the banking system, the Bank of Sudan continued to carry out its roles to entrench Islamization of banking through the establishment of the *shari'ah* High Supervisory Board in the Bank in 1993. This was to ensure that the banking operations are free of traces of usury related practices (BOS, 2006).

Usually whenever needed, the *shari'ah* High Supervisory Board in the Central Bank issues a number of *fatawa* (edicts), and resolutions in many aspects. It participated in training courses related to Islamic banking practices, and Accounting Standards for Islamic financial services and offered consultations pertaining to Islamic legal aspects.

The monetary policy of the BOS, called the financing policy, and its control instrument for the period 1990 – 2006 represents a unique one, as it reflects the experience of full Islamization of the banking system. Since the Islamization of banking has been completed the bank of Sudan has got rid of the treasury bills and government bonds instruments on which interest rates were applied. In their place the Bank has issued financial certificates that conform to the Islamic system (BOS, 1990-2006; BOS, 1990-2005). Since the beginning of the three years economic programme (1990-1993), the Bank of Sudan carried out financing policies that aimed to revitalize the Sudanese economy (BOS, 1990-2005). In 1994 the BOS, in a pioneering move, embarked upon issuing the first-ever *musharakah* bonds (*Shahama*) in order to finance governmental projects.

The BOS establishes its money and credit policy keeping in mind the requirements of the economic development of the country and other macro economic situations. The objectives of the credit policy are stated in the circulars of the central bank issued to the commercial banks from time to time (usually each year). For example, the objectives of the credit policy operative in 1990 are said to be: stabilizing the exchange rate, developing exports and maximizing revenue through exports, bridging the balance of payment deficit, encouraging

investment, organizing the role of the private sector in expanding domestic production and limiting the imports of luxury and other non basic commodities (Ahmed, 2000).

The comprehensive banking policy for (1999-2002) was issued targeting the development of the banking system at different aspects, development of management of liquidity, and entrenching the Islamization processes in the banking system. To implement those policies an annual specific work programme is laid down for every year.

The following instruments are used by the BOS to control and regulate the banking system in the country:

4.3.2 Credit Ceiling

The credit ceiling is the most important tool of monetary management and banking control in Sudan. It aims to control both the volume and the direction of credit. It is applied to all banks; however, the central bank determines the credit ceiling for each bank separately. The financial resources of the commercial bank defined as the total deposits and capital of the bank are the main criterion for determining the credit ceiling. The higher the financial resources of the bank, the higher the credit ceiling imposed on it. Banks with more branches are also usually given a higher ceiling. There is also sometimes, the possibility of having the ceiling expanded. The central bank takes punitive action if any bank exceeds its credit ceiling (Ahmed, 2000).

The objectives of the credit ceiling are: to provide incentives to production, to improve the balance of payment position and to help regulate the money supply and control inflation. The credit ceiling determined by the central bank of Sudan takes into consideration the following factors: the sources of the bank including the paid capital, subsidiary companies and deposits, the bank's financial performance, the bank's share in various subsidiary public companies and the nature of the bank concerned, the bank's financing expectation (BOS, 1990-2006). The following are used as tools for credit ceiling limits.

4.3.2.1 Priority Sectors Share

A central bank should co-operate with other authorities to achieve a balanced economic growth and development, characterised by an equitable distribution of income and growth. Therefore, a central bank may pursue a policy that decides the distribution of the Islamic banks' fund according to the need in different sectors of the economy -industrial, commercial and agricultural etc. Accordingly, the Bank of Sudan, as a central bank, issues a set of regulations and financial policies to realize its annual objectives. The extension and enforcement of these regulations concerning financing contracts are set to monitor and control money supply and demand, to direct the available fund to certain sectors according to the economic policy adopted, to protect the depositors, to reduce uncertainties arising from the present structure of property rights that tend to discourage private investment and to fund small producers.

The BOS, therefore, annually announces combined credit ceilings for what are called priority sectors, (Craftsmen, Professionals and Small Producers including Productive Families, Agricultural Sector, Industrial Sector, Export Sector, Mining and Energy Production Sector, Co-operatives, Investment in Shares, Cultural and Media Production, Private Sector Investment in Rural Services, Low Cost Housing Sector, Transport and Storage Sector). For example, in 1990, monetary policy stipulated 80% of the total bank ceiling for priority sectors, with 40% ceiling for agriculture alone. The priority sectors' share was further raised to 90% and agriculture to 50% in 1993. This policy continued although overall credit ceilings were relaxed in October 1994 (BOS, 1990-2006; BOS, 1990-2005). Financing to the priority sector share reached 95% of the total banking finance in 1998, reduced to 90% in 2000 and 2001. Almost half of this volume of finance is earmarked for the agricultural sector as stipulated by the financing policies of the BOS. For the early nineties each bank was required to allocate a percentage not less than 10% of the total banking finance to social development activities, (productive families, small producers, handicraft, and professionals). The term of finance for this sector may be two years maximum (BOS, 1990-2006; BOS, 1990-2005).

4.3.2.2 Credit Ceiling Tools for Modes of Finance

One can notice that the policies of the BOS are concentrating on financing certain sectors like the agricultural sector more than contracting out these funds. However, there are some regulations that control the finance contracts. For instance, the BOS operates three regulations: setting the first instalment percentage and the capital sharing percentage in *musharakah*, setting the minimum ceiling for the partner to invest within any *murabahah* project; setting the maximum permissible profit margins for *murabahah*. The BOS annually sets the objectives of financing policies, and rules governing extension of banking finance, as well as liquidity management through setting and monitoring quantitative monetary targets such as *murabahah* margins, customers' share in *musharakah* and administrative margins under a *murabahah* contract. Moreover, statutory reserve requirements and financing window requirements are also set (Ibrahim, 2006). These tools are discussed below:

4.3.2.2.1 Minimum Percentage of the Capital Sharing for Entrepreneurs in *Musharakah*

Overall for the period 1990-2005, we see a gradual increase of the minimum percentages of the capital sharing of the entrepreneurs in *musharakah* projects. For instance, for internal trade, it comprised 50%, 55%, 60%, and 70% for the period beginning 1993. For the priority sectors during the same period, it was 20% for three years, which then increased to 25%, and then up to 40% (BOS, 1990-2006; BOS, 1990-2005). It should be noted that the same gradual increase exists in regard to financing the production sector. This may indicate an intent to discourage the use of *musharakah*. The researcher will demonstrate in details these percentages for the period of 1990-2005 in chapter nine.



4.3.2.2.2 Profit Margins and the Minimum Ceiling for *Murabahah*

Murabahah was regulated by using a policy that set the minimum ceiling for the customers to take a *murabahah* fund. Then another policy, the maximum profit margins policy, was added in 1995. In general, the goals of these policies in addition to its monetary goals, is to discourage the customers from using *murabahah* and to persuade them to move to other finance methods. That is more obvious when we see that the use of *murabahah* or *salam* in the internal trade was prohibited during this period (BOS, 1990-2006), as the researcher will present, this policy did not meet with much success. One can notice that 1999 was the first year that these policies were left to negotiation between the bank and the customer in these finance methods as well as the marketing of banking services (Ahmed, 2003).

The cost of borrowing on average remains high in Sudan, giving the profit margins and a minimum ceiling for *murabahah*, which will be demonstrated in the empirical chapters. For example in the period 1990-93 the average minimum ceiling for the customer taking a *murabahah* fund in priority sectors, cooperative sector for production purpose and cooperative sector for non-production purpose were 25%, 10% and 25% respectively. After 1995, BOS depended on profit margins to control *murabahah* more than the minimum ceiling. The range for *murabahah* profit margins in priority sectors were between 30% - 45% in the nineties and 18% - 15% after 2000. After 2002 the percentage in all sectors has been left to individual banks to decide.

To summarise, discriminatory minimum mark-up for *murabahah* varied between 36% and 48% until 1998. After 2001, the margin has been left to the individual banks to decide (BOS, 1990-2006; BOS, 1990-2005).

4.3.3 Cash Reserve Ratio

Changes in the reserve ratio have not been frequent. In November 1986, a new credit policy was announced in which the cash reserve ratio for commercial

banks was raised to 20% from 12.5%. However, in 1988 it was 18%, raised to 20% in 1990, and 30% in 1993, then reduced to 26% in 1997 and to 15% in 2001 (BOS, 1990-2006).

4.3.4 Instruction and Directives

The BOS also issues other directives and establishes the ground rules for commercial banks keeping in mind local conditions and national economic interests. For example, the credit policy adopted for 1990 prohibits financing the working capital and domestic trade for these commodities. Similarly, the refinance of imported goods is prohibited whether the imports have been made through official or free market channels.

4.4 Conclusion

To sum up, over the nineties the economy of Sudan was characterized by severe macroeconomic instability as indicated by high and accelerating internal and external imbalances, rapid exchange rate depreciation, however, the current economic situation within Sudan is much better than it was in the late 70s, 80s and 90s. In the last five years Sudan's economic performance in recent years has been improved. Growth has been robust, inflation has been at single-digit levels, and important reforms were undertaken. The authorities attained macroeconomic stability, lifted price controls, set up liberal foreign investment and foreign exchange regimes, pursued an ambitious privatization and enterprise-restructuring programme, and began a second phase of reforms to liberalize the trade regime (IMF, 2006).

On average, all macroeconomic indicators worsened during 1990-1998. Average price inflation stood at 68% per annum, broad money supply grew at 58% and the ratio of money stock amounted to only 12% of the GDP suggesting massive disintermediation. The dramatic change in the performance of the Sudanese economy since 1998 could be attributed to a number of factors that include: (1) economic reforms; (2) favourable weather conditions affecting agriculture; and (3) high investment in oil sectors and related services. While the stabilization

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measures and economic reforms have been carried out without external aid or technical assistance and achieved success in setting high growth rates for the economy, external debt and its accumulated arrears remain to be a problem facing future development of the country.

In addition, stabilization measures have been facilitated by oil exports which gained prominence during the past few years. Oil exports increased from zero level in 1998 to reach US \$ 276 million in 1999 accounting for 35% of overall export earnings. In 2004 oil export reached US \$ 3.097 billion accounting for 81% of exports (BOS, 1990-2006; BOS, 1990-2005). With the inflow of foreign direct investments and oil revenues, the economy of the Sudan witnessed a boom in real estate development in major towns, coupled with road construction, development in telecommunications, electrical power supply and investment in food processing industries. However, despite this development, most rural areas and national agricultural development has not directly benefited resulting in accentuating poverty and continued rural migration (Hussein, 2003). The economy has been growing at a fast pace and macroeconomic conditions have been stable. Real GDP grew at an estimated rate of 8.5% in 2005, owing mainly to a recovery in agriculture and robust activity in construction and services. Average inflation in 2005 was contained at 8.5%. At end of February 2006, the 12-month rate of inflation was 5.8% (IMF, 2006).

As far as the monetary and credit policy concern and in the absence of a well developed money market, the BOS uses the legal reserve requirement ratio credit ceilings, and other direct methods of credit control as the main instruments to implement its credit policy (BOS, 2006). Until 1990, the policy instruments of the Bank of Sudan were limited. Some new instruments were announced in 1998 with the hope of introducing indirect liquidity management tools. In 1998 the BOS had introduced *shari'ah* compatible new instruments of indirect second-generation financial instruments of policy and liquidity management, as well as modifying the existing ones to strengthen monetary mechanism (BOS, 1990-2006; BOS, 1990-2005). The credit policy during the last 15 years includes three main components, the first is the credit ceiling which consists of stipulating the share of some economy sectors of the overall finance, the minimum capital for

entrepreneurs in a *musharakah* contract, and minimum credit ceiling paid by the customers in a *murabahah* as a percent of the total price of the goods, the maximum profit margins charged by banks in a *murabahah* and setting the share of the priority sectors over the total banking finance.

The BOS usually imposed detailed requirements for banking finance, dividing the economy into priority sectors and sub-sectors for which the banks were required to extend credit. Financing agriculture was a priority, other sectors were less of a priority, and some were prohibited from bank financing.

Selective methods of credit control are used to affect the direction of credit and certain guidelines are provided to allocate available credit to different sectors. In the present credit policy sectors, exports industry agriculture, handicraft and medium and long term investment projects are identified as priority sectors. A minimum of 80% of total credit provided to sectors other than the priority sectors may not exceed 20% of the credit ceiling approved for the bank (BOS, 1990-2006; BOS, 1990-2005).

The second tool is the reserve ratio. With an effective credit ceiling the reserve ratio is in practice redundant. Similarly, other instruments of indirect monetary control such as open market operations and the discount rate, which work through the reserve money department, are also virtually redundant. For the former policy to work, there needs to exist a relatively well organized financial and security market, and the bank was hardly used since commercial banks often suffered from excess liquidity rather than the reverse. Under these circumstances the BOS has frequently referred to additional methods of direct monetary control including prohibition of inter-bank lending (Elhiraika, 1998).

Lastly, the third tool is direct instructions issued by the central bank. These tools are usually contained in the BOS circulars and directives which are issued from time to time to execute the money and credit policy of the central bank. Other instruments are margins of letters of credit, foreign exchange transactions and directives in inter-bank lending (Ibrahim, 2006).

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It is also worth noting that the only permitted techniques of providing finance are *murabahah* and *musharakah*. *Mudarabah* as a means of finance is prohibited. The main difficulty faced by commercial banks in the implementation of the credit policy of the Central Bank is that most of the deposits at commercial banks are of short term projects. The incompatibility of the goals and means of monetary policy has been identified as the main constraint on the efficient implementation of monetary policy (Ahmed, 2000)

The Comprehensive Banking Policy of 1999/2000 and the following policies were explicit in advising banks to extend social support for productive families and poor sections of the community. It also called on the banks to move gradually from *murabahah* to *musharakah* mode of finance. The range for *murabahah* margin in 2001 and 2002 was 12-15%.

The financing regulations of the Bank of Sudan are still under modification, and lacks proper identification of the *musharakah* share of banking finance despite more than 15 years having passed since 1990 (Ahmed, 2004).

Having presented the developments in the Sudanese economy and monetary policy in this chapter, the next chapter studies the Sudanese banking industry to illustrate the trends and developments in a particular part of the Sudanese economy. Hence, chapter five provides an overview of the history of the Sudanese banking industry and its performance using some selected banking finance indicators. It is expected that it further provides contextualisation for the main aim of this study, namely the performance of the *musharakah* financing in Sudan.

Chapter 5 The Sudanese Banking Industry: History and Performance Overview

5.1 Introduction

The Sudanese banking system, unlike many other African and Arab systems, has gone through very frequent changes since independence in 1956. These changes were a direct result of frequent changes in the political system as well as the economic and financial policies adopted to follow the ideological beliefs that existed within these political systems. One of these major changes is the rotation between democratic and military governments since independence. Consequently, changes in economic policies occurred ranging from relative freedom and federal economic types to intervention and outright central economic ones. Shifting to Islamic banking was no exception.

The emergence of Islamic banks in Sudan started with *Faisal* Islamic Bank (FIB) in 1978. The introduction of FIB led to an unusual growth of Islamic banks which were able to attract new depositors who had been previously reluctant to deal with the existing interest based banks. In fact the decision of the *Nimeiri* government to apply Islamic *shari'ah* in September 1983 gave a great boost to Islamic banking. In 1984 a law was issued changing the whole banking system to obligatorily operate according to the *shari'ah* guidance. Since *Nimeiri's* removal from government in 1985 up to 1990 the Islamization was not taken seriously. From 1989 and onwards the Islamic direction in all financial transactions especially the banking System took on a very wide and deep direction. In fact Islam was taken, as a wider way of life, not merely restricted to financial transactions in the economy. The new 1992 Act organizing transactions in the banking system was very instrumental in changing the nature of the banking system away from its colonial nature. It should also be noted that the intentions of nationalization, that took place in the seventies, largely delayed the more

efficient development of the Sudanese banking system.

Sudan's financial sector is small and under-developed after over two decades of civil conflict. In order to have an idea about the banking environment and operations, which is the subject matter of this research, the researcher attempts to discuss the emergence of the Islamic banking, and to assess the overall performance of the banking industry and, therefore, this chapter demonstrates some selected indicators and gives a fundamental background about these performances in the banking sector. The second section is devoted to the history of the Sudanese banking industry; the third section discusses the performance of the banking industry. The last and fourth section is devoted to any conclusion drawn from the previous sections.

The Sudan provides a unique example of a modern attempt to recreate the banking system according to Islamic principles. This chapter is meant to shed light on the genesis of the Islamic banking within the history, and the performance of the banking industry in Sudan.

5.2 History of the Sudanese Banking Industry

5.2.1 The Banking Industry 1956-1983 (Independence and Nationalisation)

5.2.1.1 Post Independence Period: 1956-1969

At birth, Sudan inherited a traditional banking system, which was introduced earlier when the country was a part of the British Colony. The commercial banks were part of the foreign institutions and there was neither a central bank nor local currency (Abdel Mohsin, 2005). The financial institutions that existed before independence were mainly the National Bank of Egypt (NBE), Barclays DCO, the Ottoman Bank, Banque Misr and Credit Lyonnais. They were all branches of foreign banks. In 1950 foreign capital was in full control of the banking and insurance sector. Barclays bank virtually controlled the banking sector up to independence. Afterwards, competition led to the establishment of new foreign banks including branches of the French owned credit Lyonnais and of the other

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Egyptian, Ethiopian, Jordanian based banks. The year 1956 witnessed the establishment of two banks, the first national bank (Sudan Commercial Bank) and a branch of the Arab Bank (Jordan). In 1957, when the branches of foreign banks became reluctant to undertake assisting agriculture as a result of the cotton failure, the Ministry of Finance decided to establish an agricultural specialized bank, namely the Agricultural Bank of Sudan which started its operation in 1959.

After Sudan achieved independence, there arose a need for a Central Bank to replace NBE which opened in Khartoum in 1901 and obtained a privileged position as banker to and for the government as a semi-official central bank besides being a commercial bank. It was serving as the fiscal agent and lender of last resorts for other commercial banks (Bank of Sudan, 2006). A need for a Central Bank became exigent after the independence when the government embarked upon grand scale economic programmes which necessitated effective monetary and financial policies that would cope with those ambitious Sudanese economic programmes (Shaaeldin and Brown, 1985). A Sudan Currency Board (SCB) was established in 1957 to start issuing a national currency which took over this responsibility in place of the NBE in 1958. There after, the Bank of Sudan commenced its functions in February 1960, to become one of the first operational central banking institutions in Africa, with the main aims of regulating issuance of currency and coins, to help regulate the banking system, the monetary and the finance systems in the Sudan, and to work to ensure financial stability, to achieve economic development in the country in a systematic and a balanced fashion, to consolidate external currency stability, to be the bank of the government and its advisor in financial affairs (Bank of Sudan, 2006).

In addition, in 1958, the Ethiopian Commercial Bank was allowed to open a branch in Khartoum as a token of good relations with Ethiopia. The Credit Lyonnais accepted that the government take over 60% of its capital and was renamed “*El-Neilein Bank*” (Ali, 1977). In 1961 and 1967 two governmental specialized banks started, one in industries financing (Industrial Bank of Sudan 1961), the second in housing finance (Real Estates Bank 1967). In addition, in 1969, the National and Grindleys was established taking over the assets of the

Ottoman Bank (Ali, 1982). The sixties witnessed a gradual ‘Sudanisation’ of banking.

Therefore, the structure of the Sudanese banking system between independence and just before the nationalization period included the Central Bank, six branches of foreign banks, two commercial and national mixed banks and three specialised banks.

5.2.1.2 Nationalisation Period: 1970-1975

Prior to 1970, the commercial banks in the Sudan were, with the exception of the Sudan commercial banks, all foreign owned (Ali, 2001). Policies emerged that nationalization was imminent when *Nimeiri* ended the second democracy in Sudan’s post independence period. On May 1970, one year after the coup, *Nimeiri* declared the nationalization of all banks and foreign branches, firms and business of many members of the foreign communities as well a famous Sudanese business family. It even included the only national bank, Sudan Commercial Bank, which was established in 1960 (Ali, 1982).

After nationalisation, Barclays DCO, National and Grindleys, The Ethiopian Commercial Bank, The Arab Bank, and Banque Misr became State Bank for Foreign Trade, *Omderman* National Bank, Juba Commercial Bank, Red Sea Commercial Bank and Peoples’ Cooperative Bank followed suit. *El-Neilein* Bank, Sudan Commercial Bank and the specialized banks retained their names, but all in addition to the foreign banks came under direct government control. The Bank of Sudan had, however, absorbed the NBE and whatever responsibilities it used to shoulder in pre-independence Sudan (Bank of Sudan, 1990-2005).

Among many, the main objectives of nationalization at the time were to promote exports and enhance their proceeds, attract the savings of Sudanese working abroad (SWA), promote competition among banks to improve banking services in rural and distant areas, and ending of foreign control over national capital (Shaaeldin and Brown, 1985).

In 1973 some banks changed their names to initiate some openness after the tough nationalisation period, in the following way: State Bank for Foreign Trade (1970) became Bank of Khartoum (1975), *El-Nilein* Bank merged with Red Sea Commercial Bank (1973), *Omderman* National Bank (1970) merged with Juba Commercial Bank for Juba *Omderman* Bank (1973) then was renamed Unity Bank (1975) (Ali, 1982). Others remained as they were, Sudan Commercial Bank, Peoples' Cooperative Bank, Agricultural Bank of Sudan, Industrial Bank of Sudan, Real Estates Bank. Moreover, in 1973 a Sudanese Savings Bank was established.

5.2.1.3 The Emergence of Islamic Banking and the Establishment of Faisal Islamic Bank in the Seventies

In 1978 *Faisal* Islamic Bank, which was the first distinctly Islamic financial institution to set up offices and do business in the Sudan whose principal patron was the Saudi prince, Muhammad Ibn *Faisal* Al Saud, started operations in Sudan. FIB was established on terms which were very similar to those granted to the *Faisal* Islamic Bank to operate in Egypt the previous year (Ahmed, 1997).

The *Faisal* Islamic Bank was established by a special Act of Parliament (the *Faisal* Islamic Bank Act) and was registered as a public limited company under the Company Act of 1925, and commenced its operations in 1978. At the ideological level, the revival of Islam was closely associated with drive for extension of capital accumulation in the region. It is also important to note that the revived interest in Islamic banks followed the oil boom and massive accumulation of petro-dollar surpluses in the Middle East after 1973. Members of the Muslim Brotherhood, an Islamic movement originated from Egypt, and its political arm, the National Islamic Front, played a prominent role on the board of directors of the *Faisal* Islamic Bank, thus strengthening the bank's position in Sudan (Stiansen, 2004).

The unprecedented parliamentary Act gave the bank very valuable concessions denied to other commercial banks, such as tax exemptions on all assets and profits, as well as employees' salaries and pensions, and complete freedom to

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transfer and use its own foreign currency deposits as well as guarantees against confiscation or nationalization.

The paid up capital of *Faisal* bank increased aggressively from 0.6 to 2 million Sudanese Dinars in less than 4 years, the average growth rate was 70% making the bank much better capitalised than commercial banks (Faisal Islamic Bank, 1979-2005). This increase represented 17% and 30% of the total paid-up capital of 18 commercial banks at that time, both private and national. During that time, the shares were divided between Saudis, Sudanese and other Muslims in the ratio of 4:4:2 respectively (Shaaeldin and Brown, 1985).

The claim that the *Faisal* Islamic bank is first and foremost a Muslim institution has been effective in distilling certain sensitivities in Sudan to the penetration of foreign capital, and in particular, to the foreign banks (Ali, 1977). The *Faisal* Islamic bank is, therefore, perhaps the most significant of all policies and developments in the Sudanese banking witnessed in the seventies and early eighties because of its gradual emergence as a new finance capital (Shaaeldin and Brown, 1985).

Nonetheless, many years later claims were raised that some members of the Muslim Brotherhood favoured other members of the movement, and political criteria carried more weight than the quality of the business proposal (Stiansen, 2004). Internal audits and audits by the Bank of Sudan revealed that in many banks, members of the board of directors and/or senior management monopolized borrowing, and the default rate on such loans was in general very high (Ahmed, 1997).

A striking feature of the formative phase of Islamic banking in the Sudan was how closely the different banks were associated with different political groups. The Sudanese Islamic bank SIB had close ties to the *al Khatmiyyah* Sufi group and therefore also to the Democratic Unionist Party. The *Tadamoun* Islamic bank TIB had very close links to the Muslim Brotherhood. Notably, the *Umma* Party, the biggest party at that time did not have its 'own' bank (Stiansen, 1999).

All these banks succeeded in attracting more depositors, and hence, more branches were opened all over the Sudanese States.

5.2.1.4 1975-1983

A new Investment Act in 1976 was passed in an attempt to attract foreign investors in all fields. As a result of these policies a number of foreign and local bank branches were established together with Islamic banks in the period between 1976 and 1983 when the banking system was finally Islamised. It is interesting to note however that at this stage it has been mainly US regional capital that moved in replacing the early European influence in Sudanese banking. However, this period was characterised by political and environmental crisis, which led to structural changes in the country (Bashir, 1999).

In the seventies some foreign banks had opened branches in Sudan namely Abu Dhabi National Bank (UAE), BCCI, Citibank (American), Sudanese French Bank, Oman Bank Ltd (Jordan) (name changed to Al Mashriq Bank in 1982), Sudanese Ahli Bank, Middle East Bank (liquidated in 1992), the Pakistani owned Habib Bank, the Bank of America, International Bank of Credit and Commerce, and the Islamic Bank for Finance and Development.

As yet these banks had been restricted from dealing with Sudanese citizens although they could open accounts for import-export agents and Sudanese nationals working abroad (Shaaeldin and Brown, 1985).

The Sudanese banks established in the same era are National People's Development Bank (1982), National Export & Import Bank (NEIB) (1983), and Blue Nile Bank (BNB) (1983). The unusual success and attraction of *Faisal* Islamic Bank encouraged others to establish similar Islamic banks namely the Sudanese Islamic Bank SIB in 1983 and Islamic Development Cooperative Bank IDCB in 1983 and *Tadamoun* Islamic bank TIB in 1984

5.2.2 First Islamization Period: 1983-1985

The adoption of the *Shari'ah* Law was realized in September 1983, but the full Islamization of the Sudan Banking system was completed in 1984. The 1984 Civil Transactions Act prohibited the use of interest in the whole system and many other financial transactions (Government of Sudan, 1984). The banking system was directed by the Bank of Sudan to use Islamic formulae in financing their activities.

The Islamization of the banking system in Sudan was initiated by a presidential order from President *Nimeiri* instructing the Governor of the Bank of Sudan to implement the process immediately. This resulted in an immediate instruction from the Governor to the conventional banks to make themselves Islamic as from July 1, 1984 allowing them only a few months' time. This left virtually no time for advance studies or preparations to be taken by the conventional banks to convert themselves Islamic. As a result, most of the banks tried to replace interest transactions with *murabahah*. No committee conversed in religious guidance was formed and consulted. Lack of carefulness was also noticed by the incident that no supervisory techniques for Islamic banks were designed by the Central Bank (Stiansen, 1999).

During this sub-period the following banks were established: Baraka Bank Sudan (1984), Islamic Bank for Western Sudan (1984), The Sudanese Saudi Bank 1986, National Workers Bank (1988) and *Al Shamal* Islamic Bank (1989) (Ali, 2001).

After the 1985 popular revolt which ended the 16 years of *Nimeiri* rule, the transitional government had given over the country after ruling for one year to the political parties. The political parties, especially the *Umma* Party, were very critical of the application of *Shari'ah* laws in September 1983. As a result of that, the banking system was prohibited from using the concept of interest. Therefore, banks were given, during the third democratic period, the choice to use the Islamic formulae or alternatively, what was innovated by the *Umma* party as, the Compensatory Return. This was considered especially by the National Islamic Front as *riba* and reversal of Islamic *shari'ah* as adopted by the Islamic banks

(Ali, 2001). After 1985 many of the traditional banks reverted back to their conventional practices. On the other hand Islamic banks were forced to operate in an extremely hostile environment characterised by negative media coverage, lawsuits, and heavy regulations. Meanwhile, the Sudanese economy was suffering from serious structural problems; drought hit the country, unsuccessful economic policy appeared clearly in the high devaluation of the Sudanese pounds, and high increase of external debts (Bashir, 1999).

It is notable that, this period witnessed the establishment of new banks on an ethnic and professional basis. For example, while the Islamic Bank for Western Sudan was initiated by businessmen and citizens from Western Sudan to develop the Western Region, *Al-Shamal* Islamic Bank was established in 1990 mainly by sponsors from Northern Sudan together with the Sudanese from the north working abroad as well as some Arab businessmen. By contrast, the National Workers Bank was established by the Sudan Workers Union. This could be attributed to the overall disenchantment of various regions and professional or unions' groups with the content of development. Many, especially those from Western Sudan, thought that the central government was giving lip service to their development. Such and other sentiments emerged in the 1985 revolt reflecting the marginalization of the rural poor especially in Eastern and Northern Sudan. The Ivory Bank as a bank for the South came later (Ali, 2001).

5.2.3 Post Islamization Period: 1985-1989

Nimeiri's programme of Islamization proved to be the regime's swan song. In 1985, the people took to the streets to protest the escalating economic crisis and abuses of power, and the military intervened, installing a transitional government. Composed of both serving soldiers and civilians, the transitional government suspended some Islamic laws, but basically the Islamic nature of the judicial system remained intact when the democratically elected government of Sadiq al-Mahdi came to power in 1986.

Upon the reassessing of the banking law from the new prime minister, the Governor of the Bank of Sudan issued a circular called The Banking Tariff- the

compensatory rates on October 1987, by which some banks reverted back to dealing with interest. The brief circular contained neither a technical definition of compensatory rates nor an explanation of how such rates were different from interest rates (Stiansen, 1999). The introduction of compensatory rates did not, however, lead to the phasing out of *murabahah* contracts. The reason was quite simple: while the compensatory rates effectively capped the banks' return on loans (at rates that were below inflation), there was no upper limit on the mark up implied in *murabahah* sales. Consequently continued use of the most adaptable Islamic financial technique enabled bankers to increase their profits and beat inflation (Stiansen, 2004).

Described as a means of enriching the Islamic experience and meeting the needs of the contemporary economic situation, the contemporary rates were set at 27% per year for all debt accounts, except for loans for the industrial, agricultural and export sector, whose compensatory rate was set at 24% per year. For credit accounts and savings accounts, the compensatory rates were fixed along a scale beginning at 2% for three months deposits and 20% respectively. The rates for pensions and life insurance premiums were equal to the rate saving accounts (Stiansen, 2004).

5.2.4 The Second Islamization Period: 1989-2005

The military government that took over in June 1989, was known later to have been supported from behind by the National Islamic Front Party NIF. In June 1989 all the banking system was Islamised, thus eliminating the choice given to banks to operate on a two tier arrangement as it was before (Ali, 2001).

The military coup of June 1989 led to abolition of compensatory rates, and in 1990 the government tried to be more principled in the application of the Islamic laws in the banking sector. In this respect the first effort was to supplement the Company Law of 1925 with the new Banking Regulation Law of 1991 and the Compendium of Administrative and Financial Penalties against Banking Violations of 1992. But these laws and regulations did not address the issue of Islamic finance as such, even though several paragraphs established that no

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banking law or practice could contradict the *shari'ah*, the new laws did give, the Bank of Sudan the right to fix profit margins, fees and commissions, and to decide procedure for the calculation and distribution of profits (Stiansen, 1999).

In 1991 two steps were carried out; one was the privatization of the Sudan Commercial Bank that came under the ownership of the Farmers' Bank for Rural Development as a holding company. In the same year a law was passed called Organization of Banking Operations Act which aimed at bringing under the Bank of Sudan's supervision and for the first time, many other institutions that deal in financial resources such as, insurance companies, local financing funds, and the companies that deal in financial resources (Ali, 2001).

In the same year, BOS freed the decision to commercial banks to establish commercial bank branches not as it used to be before in which a complicated procedure needed permission from the BOS. This encouraged many commercial banks to explore the regions of potential economic activities and then decide to open branches there to attract more resources.

In order for the Bank of Sudan to enhance its control over the banking and financial system, regulations were enunciated. In 1992 status and rules were made to take care of administrative and financial penalties for banking irregularities. A more comprehensive attempt by the government to detail proper Islamic financial procedures came in March 1993 when the Bank of Sudan's Supreme Board for *shari'ah* Supervision issued a circular setting out requirements of legal *murabahah* contracts. The objectives of the *shari'ah* Board were the deepening of the Islamization of the banking system foremost, the issuance of fatwa and advice on how to solve problems on the basis of *shari'ah* as well as training the staff of these banks and deepening in their minds the Islamic methods and formula. In order to spread Islamic *shari'ah* culture, all the commercial banks followed Bank of Sudan in establishing their own *shari'ah* Supervisory Unit. This was to ensure that the banking operations were free of traces of usury like practices. In this way a full *shari'ah* supervision of the Sudanese banking system was achieved in all banks as well as in the Bank of Sudan.

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In an effort to mobilize resources for development, a Securities Market was also established in August 1992 for the first time in Sudan's recent history. It formally started its operation in January 1995.

In 1993 three more banks came into existence namely; AI Safa Credit Bank, (which started originally as an Investment bank); *Omderman* National Bank, which is a form of military bank and Animal Resources Bank which aims to develop and promote the animal resources of the country (Bank of Sudan, 1990-2005).

During this period, certain commercial and development banks belonging to the State were merged: Unity Bank and National Export Import Bank were merged into Bank of Khartoum and renamed Bank of Khartoum Group. The Industrial Bank of Sudan was merged into *El-Neilein* Bank and renamed as *El-Neilein* Industrial Development Bank Group. The Middle East Bank and BCCI were liquidated. Oman Bank Ltd was renamed as Al Mashriq Bank (Bank of Sudan, 1990-2005). In addition, in order to reshape and reorganize these banks, the banks were required in 1994 to restructure their financial positions in accordance with the recommendations of Basle Committee within three years starting 1994 (Kireyev, 2001).

In the same year (1995) an important development took place, which was the emergence of a new bank named Ivory Bank, whose major objective was to finance human development in the Southern Region. In fact the bank is supported by the government and is almost fully manned by trained bankers from the Southern Region (Bank of Sudan, 1990-2005).

These years were very intensive years during which a form of 'keeping the system' was undertaken to fall in line with the liberalization policy adopted, as well as to raise the standards of the commercial banks to fall in line with international requirements of capital and efficiency as enunciated by the Basle Committee (Kireyev, 2001).

In 1996-1999 further developments took place; the Sudanese Savings Bank was

converted into the Savings and Social Development Bank. Two commercial banks ceased to operate as Citibank (1998) opted for voluntary closure and Nima Bank was liquidated in 1999 (Bank of Sudan, 1990-2005).

5.2.5 The Dual Banking System: 2005 and After

In 2006 a joint partnership between Ahli Bank and Audi bank (Lebanon) established Ahli Audi Bank with \$75 million paid capital in an exchange of 75% of the Ahli Bank's share. In addition, *El-Neilein* Bank was sold to Alsalam Bank (United Arab Emirate Investments) (Alray Ala'm, 2006).

In Dec 2006 the Sudanese currency was changed to the Pound instead of Dinar, as for the south, according to the Peace Agreement started by the southern Sudan where Ethiopian, Kenyan and Sudanese currency was in use before the peace. For the north the change will take place at the end of 2007.

According to the peace agreement, the BOS were restructured, during the pre-interim period, so as to reflect the duality of the banking system in Sudan. Two sets of banking systems were developed in 2006 one Islamic and the other conventional. The Bank of Southern Sudan (BOSS), headed by a deputy governor of BOS, is managing the conventional window using conventional financing instruments in implementing the same national monetary policy, set by the BOS in the north for the Islamic banks, in southern Sudan.¹ In addition, in 2006, Kenya's biggest retail bank, Kenya Commercial Bank (KCB), opened two branches in 2006 in southern Sudan. However they are more open to organisations than individuals, since the two cities in which the branches operate serve as the headquarters of the United Nations and various aid agencies working in southern Sudan and the economic activity seen there has been concentrated on the work of aid organizations.

A dual banking system presents both opportunities and challenges for improved financial intermediation and management. The coexistence of Islamic and

¹ For the full context of the Peace Agreement see www.gurtong.org

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conventional financial institutions will undoubtedly increase competition and expand the range of financial services to attract greater savings and borrowing by Muslims and non-Muslims. At the same time, managing a dual banking system should not present any serious challenge in view of the experience of the BOS in supervising and regulating both interest-based and Islamic institutions in the past. In fact, in most countries where Islamic banks exist, there is a dual banking system. These countries include Malaysia, Saudi Arabia, Bahrain and the United Arab Emirates. Dual banking systems in these countries significantly contribute to financial development while presenting no serious banking management problems.

It is expected that the dual banking system would enhance public confidence in banks and open the door for them to mobilize greater resources. Coexistence of Islamic and interest-based financial institutions will also widen the array of financial products available to savers and investors, while competition within and between the two segments is expected to improve the quality of services. Meanwhile, there is a wide scope for cooperation between Islamic and conventional financial institutions. Conventional banks have been offering Islamic financing facilities since the early 1980s, both within and outside the Muslim world (Wilson, 2002).

The competition between Islamic and conventional banks might not be strong since Islamic banks are allowed only in the north and conventional banks in the south. However, Islamic banks may compete with conventional banks in some areas but there are many areas for them to cooperate and complement each other. There is no reason for a dual banking system to disrupt the basic functions of the financial system, especially regarding the development of efficient payment mechanisms.

As far as the regulatory and monetary policy for the case of a dual banking system is concerned, it is possible for the Central Bank, in theory and practice, to regulate Islamic and conventional banks with special law(s) for each segment (Chapra and Khan, 2000), notably, that many of the regulation measures developed by the Basel Committee are also applicable to Islamic banks with

some modifications. However, the mission is not simple nor is it easy to control and monitor a system with an interest based system and another one that is equity-based with PLS instruments (Elhiraika, 2004).

The policy implication of this duality is that macroeconomic policy framework will have to take into account the needs on the one hand of a post-conflict economy of the south, and on the other the requirements of economic stability of the economy of the north. For the economy of the north the IMF has already established stringent monetary and fiscal targets aimed at maintaining macroeconomic stability. Such a policy prescription is consistent with the required GDP growth rate of 6.7% over ten years in order to reduce poverty by half in northern Sudan by the year 2015. Sudan (i.e. northern Sudan) has already achieved this rate according to the IMF and what is needed is to maintain macroeconomic stability.

5.3 The Performance of the Sudanese Banking Industry 1990-2005

5.3.1 Introduction

The Sudanese banks are very small by international standards. The paid capital together with the reserves of the Sudanese banking industry as a whole, at the end of 2005 was 183862 million Sudanese Dinar (SD) (\$750 million) with an increase of 27% compared with the year before (Bank of Sudan, 1990-2005). The deposits for the entire banking system were SD 977,595 million (\$3910 million) in 2005 with an increase of more than half compared with 2004. While the credit capacity used in 2005 was SD 700018 million (\$2800 million), the total asset of the Sudanese banks was SD 1530310 million (\$ 6121 million). The share of the lending capacity over the total sources in 2004 was 71%, while the share of the capital and reserves and profit are 26% and 3% respectively (Bank of Sudan, 1990-2005).

5.3.2 Selected Banking Finance Indicators

Table 5.1 summarizes some selected financial and performance indicators of the Sudanese Banking system during 1990-2005.

Table 5.1 Selected Banking Finance Indicators

	Deposits Million dinars	Total deposit/ GDP %	Change on deposits %	Deposits /liabilities %	Total finance	Banking finance /GDP %	Finance /assets %	Finance /deposits %
1990	1650	1.5	301	67	767	7	13	48
1991	2986	7.4	316	66.6	1403	7.4	13	47
1992	9445	11	77.1	64.4	3311	10.1	22.7	35
1993	16734	9.5	40	402	5273	5.7	12.7	31.5
1994	23435	9.9	77	40.7	10073	7.7	17.5	43
1995	416419	10.1	16	40.2	14140	3.5	14	34.9
1996	67792	6.2	3.16	42	33950	3.1	21	50
1997	96753	5.3	42.7	41	41556	2.3	18	43
1998	120113	5.3	24.14	37	47383	2.1	14	39
1999	145519	5.4	21.2	35	48732	1.8	11	32.8
2000	197224	6.2	35.5	55	79224	2.5	22	40.2
2001	274188	8	39	60.2	111339	3.2	24.5	40.6
2002	363074	9.1	32	59.4	160020	4	26.2	53.2
2003	472952	10.3	30.3	59.9	294759	6.4	37.3	62.3
2004	646649	11.7	36.7	61.9	436391	7.9	41.8	67.5
2005	977595	14.6	51.2	63.88	700018	10.4	45.7	71.6

Deposits and finance up to 1993 in pounds and after in dinars, one dinar equals 10 pounds.

Source: IMF, Bank of Sudan annual reports and the researcher calculation

5.3.3 Deposits, Finance and Assets

According to table 5.1 the Sudanese Islamic banks succeeded in attracting people to deposit in them, since the total deposits increased from SD 1650 million in 1990 to more or less one billion Sudanese Dinars in 2005. Deposits as a share of the GDP increased as well from 1.5% to more than 14% in 1990 and 2005 respectively. Moreover, these Islamic banks succeeded in financing many areas, as their total finance increased from SD 767 million in 1990 to more than SD 700 million in 2005. All these can be attributed to the increase in the demand for the new Islamic Banks and their branches in all the regions of Sudan (Abdel Mohsin, 2005).

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However, total deposits as a percentage of GDP are very low by any standard. The ratio was up to 15%, compared to more than 40% in Egypt and Jordan, respectively. Investment deposits have never exceeded 2% of GDP in the 1990s (Hussein, 2003). The average finance to economic sectors as a percentage of GDP was less than 6% in 1990-2005.

The demanding deposit accounts have succeeded in attracting more depositors compared to investment accounts as the share of the demanding deposits in national currency is over 80% of the total deposits in most of the Sudanese banks. On the other hand, saving and investment deposits remain relatively small (Hassan and Hussein, 2003). Despite the high growth rate of saving and investment deposits compared with current deposits reported by some researches (Ibrahim, 2006), the short-term current and demanding account deposits and long-term saving and investment deposits is still exactly evenly distributed.

Ibrahim (2006), referring the majority of Sudanese Islamic Banks (SIBs') preference of demand deposits to the fact that the majority of the SIBs do not wish to share profits with them while they can still use the short term deposits for short term finance, compared with a few SIBs who are hunting to attract investment deposits. However, Kireyev (2001) argues that this phenomenon is a reflection of the cash nature of the Sudanese economy, where individuals prefer to have instant access to their funds. Similarly, in the same direction, Hassan and Hussein (2003) argue that this phenomenon reflects the failure of the banking sector to offer investment opportunities to suit potential depositors.

In addition, for the reason that inflation rates in the 1990s were much higher than any profits that banks might distribute to depositors, individuals invested heavily in properties instead of banks deposits which can be seen clearly from the share distribution of the foreign currency deposits as it is almost 50% for each demand and investment deposit in the same year. Indeed, the banks themselves used to invest in the property sector until 1995, when the Bank of Sudan (BOS) prevented the practice (Bank of Sudan, 1990-2006):

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Hussein (2003) further added that the average volume total of commercial banks' deposits in the period 1990-1994 was about 52.4% of that in 1980-1984, but the decline in commercial banks' assets was less accentuate. This decline is in contrast with the experience of Iran and Pakistan, where Islamic instruments resulted in an increase in such deposits. However the share of medium and long term lending in total bank credit has increased in the post Islamic period. This was perhaps due to the fact that the credit policy continued to encourage such type of credit while restricting the volume of the other as well as total loans. Indeed, when much of bank lending capacity remained unused, the volume of medium and long term loans fell dramatically in real terms (Elhiraika, 1998).

The assets composition of the Sudanese banks also contrasts with other Islamic banks in other countries. In Sudan, banking finance to economic sectors constitutes a small fraction of total assets. Sudanese banks maintain a large proportion of their resources in liquid assets since short-term deposits dominate the liabilities side of the banking balance sheet (Hassan and Hussein, 2003). Reports show that banking finance to economic sectors as a percentage of total assets accounted for 14%, 21%, 17.5%, 14.4% and 11.5% in 1995, 96, 97, 98, 99, respectively. Sudanese banks are mainly engaged in non-fund financial services whereby off-balance sheet transactions generate 46% of the banking income, compared to 37% from banking finance to economic activities (Hussein, 2003). Several banks extract almost 70% of their net profits from administration fees and charges imposed on customers (Kireyev, 2001). However, banking and finance as a percentage of the GDP has decreased in the 1990s but increased between 2000 and 2005.

Hussein (2003) points out that banking finance (in real terms) declined by 46% in 1990-2000. The growth rate of banking finance to private and public sectors were 82% and 20%, respectively, through the 1990s. Kireyev (2001) points out that finance to the private sector (in real terms) was shrinking annually by 16% between 1991 and 1993, 1.5% between 1994 and 1996, and 6% in 1997-99. Overall, finance to the private sector declined by 23% in 1990-1999. Among other reasons, Kireyev (2001) argues that the decline in banking finance in the 1990s is due to the fact that Sudanese banks do not have much access to lines of

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credit from abroad, inefficiency of the banks and the excessive BOS intervention. The capital and deposit bases are not sufficient for increasing finance. Banks consider the risk of extending finance to all sectors, other than trade, high.

The cost of borrowing remains high in Sudan. For instance, the *murabahah* real rate of return was in the range of 9.7-16.7% in 2000. In addition, Sudanese banks prefer to buy the Central Bank *musharakah* certificates with a higher rate of return compared to financing private sector (Hussein, 2003).

As table 5.1 shows, the advanced finance to economic sectors was, as a percentage of GDP, on average less than 3% in 1991-2001. The ratio of financial resources to GDP did not exceed 12% and total banking assets to GDP was about 20%. The adaptation of the Sudanese banking system to the requirements of the Basle Commission's capital sufficiency standard requires the banking system to look at internal problems rather than external, including their role in alleviating poverty. In general, finance over assets ratios has improved which indicates the increase of the lending capacity. This was the case with finance over deposit ratios.

Finance-to-deposits ratio provides a measure of risk taken as demonstrated by the degree to which resources are extended. It gives an indication of the ability of the banking system to mobilize deposits to meet credit demand. In Sudan, the average ratio of finance to deposits was 40% in the 1990s. This indicates no pressure on the whole banking system, and a high level of liquidity to respond to shocks. But the low ratio also reflects weak inflow of financial resources into the development process of the country. This percentage has increased after 2000, when it reached 71% in 2005 as shown in table 5.1.

5.3.4 Profit and Expenses

The profits of the Sudanese banks are very low compared to international standards, where the ratio of total expenses to total revenues exceeds 55 % in all Sudanese banks apart from the foreign ones. For example, the ratio of total expenses to total revenues reached 98 % in public and joint banks in 1997. Total

expenses exceeded total revenues by 30 % in government banks in 1999 (Bank of Sudan, 1990-2005). Kabir and Hussain (2003) argue that low efficiency in assets management, high ratio of non-performing loans, and low productivity of labour are the main hurdles to increasing operating revenues in Sudanese banks. In addition, the high total expenses are due to the absence of good governance, high staff and administration cost, the small size of Sudanese banks, and the slow process of introducing modern technology to banking operations. The average staff and administration costs in the Sudanese banks is 9 % of total assets and as high as 20% in some banks (Kireyev, 2001). However the last five years witnessed some mergers and, administrative reform was conducted which resulted in the reduction of the staff, and the merger and reduction of branches and departments to control operational expenses. The bank is also gradually implementing the Basel Committee measures for the control of various risk aspects.

The currency circulated outside banks as a percentage of currency circulated inside the banking system has always been above 90% since 1990. For example, the currency outside the banking sector was 92% in 1995, 91% in 1996 and 1997, and 95% in 1998 and 1999 (Hussein, 2003). Therefore, the performance of deposits is relatively at an acceptable level.

5.3.5 Sectoral Distribution of Financing

The sectoral distribution of banking finance in Sudan is depicted in table 5.2.

Table 5.2 Sectoral Distribution of Financing (1990-2005)

	Agriculture %	Industry %	Exports %	Imports %	Domestic trade %	Other sectors %	Total finance (million of S.D.)
1990	11	23	28	3	10	25	767
1991	27	20	18	2	14	20	1403
1992	34	14	17	1	12	22	3311
1993	35	16	22	1	6	20	5273
1994	29	18	22	1	6	24	10073
1995	25	18	27	9	3	19	14140
1996	27	19	20	5	4	27	33950
1997	31	18	20	2	4	25	41556
1998	33	19	17	1	4	26	47383
1999	30	15	17	3	6	29	48732
2000	23	11	21	1	10	34	79224
2001	18	15	16	4	19	29	111339
2002	14	13	14	4	23	32	160020
2003	13	11	13	1	32	31	294759
2004	10	12	10	1	36	31	436391
2005	7	15	6	3	32	38	700018
Average	23	16	18	3	14	27	124271

Source: Bank of Sudan annual reports and the researcher calculation

Up to 1991, commercial banks' advances to the agricultural sector stood at less than 1% of their total advances. As a result of the National Economic Salvation Programme initiatives to activate agriculture and to achieve food security, the number of bank branches in rural areas was more than doubled, and the ratio of farm credit rose to an average of 18% during the period 1990 – 1993 (Elhiraika, 1998).

For the period 1990-2005 the table 5.2 displays the massive increase on the total finance starting from SD 767 million in 1990 to SD 470025 million in 2005. This increase in financing is not evenly distributed among sectors. The agricultural and industrial share is an average of 40 per cent of the total banking finance. The share of trade-related financing (exports, imports and local trade) shares is over 35%.

The table 5.2 also shows the decrease of financing agriculture as it reached 7% in 2005 while it was 35% in 1993. By contrast, it is possible to conclude that the sectoral distribution of finance during this period favours trade and commerce. As the decrease in agriculture finance was in favour of the increase of local and domestic trade finance, while it is the other way around from 6% in 1994 to 32% in 2005. It is worth noting that since 1999 no minimum finance is required for the agricultural sector, financial institutions are free to allocate finance to different sectors of the economy without BOS intervention. Moreover, Ibrahim (2006) reported that the analysis of sectoral lending in 1990-2005 shows that about 74% of the combined total lending of commercial banks was directed towards modern agriculture, industry, and exports. Small producers shared only 6% of the total lending. These led Tarik (1996) to conclude that the emerging corpus of facts about the operations of Islamic banks over the last two decades sheds serious doubt on their ability to perform this role (channelling financial resources into long-term investment projects in productive sectors of the economy on the basis of equity) which is vital for economic growth.

5.3.6 Nonperforming Loan (Investment)

Non-performing loans as a percentage of total banking finance is quite high in Sudanese banks. For instance, Abdullah et al (2000) show that according to the BOS publications the non-performing loans ratio was 44%, 24% and 16% in 1998, 1999 and 2000 respectively. The non-performing loans ratio is higher in public banks compared to the joint banks. For example, in 2000 the non-performing loans ratio was 28% in public banks and 17% in joint banks (Bank of Sudan, 1990-2005). The increase in non-performing loans as a percentage of total finance in the late 1990s was mainly due to the decline of the overall finance activities. Also the high level of non-performing loans is due to the tight definition that the BOS use of such loans whereby an overdue loan by one month is considered as non-performing.

Non-performing loans to total loans reached 17% in 2000, and there is a declining trend thereafter. This reflects poor credit performance and defaults of big clients. However, the ratio has fallen consistently in recent years to 14.5%,

8.9% 6.9% in 2003, 2004 and 2005 respectively. During the same period, capital adequacy ratio for the banking system increased from 10.8% to 12% (IMF, 2006). In 2005 while credit expanded rapidly during the year, the ratio of nonperforming loans to total loans decreased from 8.9% in December 2004 to 6.9% at the end of 2005. The asset quality of banks also improved. As of December 2005, a total of 18 banks (out of 29 banks) complied with capital adequacy requirements. As for the concentration of credit, almost 40% of the increase in credit to the private sector was granted by a single bank (IMF, 2006).

It is worth noting that foreign banks did not record non-performing loans because they mainly engage only in trade transactions with low risk of default. Abdullah et al (2000) examined the non-performing loans for 1994-1998. They conclude that among the Islamic modes of finance, *murabahah* is the main contributor to non-performing loans. The exports sector has the highest non-performing loans as a percentage of total non-performing loans (38%). Furthermore, 28% of the non-performing loans are due to defaults in the agricultural sector. Ahmed (2005) has reached other findings for the period 1993-1999, for him *musharakah* was the main contributor with 49% compared with 41% for *murabahah*.

There are several reasons behind the increase in non-performing loans: First; the absence of the price mechanism to allocate finance among different sectors and projects led by bankers to use other and less efficient measures to screen potential investments. Secondly; banks do not have sufficient information on customers and investment opportunities. Thirdly; the performance of the main economic sectors (agricultural and industry) are vulnerable to several external factors such as drought and change in foreign prices (Abdullah et al., 2000, Ahmed, 2005).

Since 1999 the BOS has pursued a tight policy in dealing with non-performing loans. Banks should report on their non-performing loans to the BOS on a monthly basis and penalties are imposed on noncompliant banks. If non-performing loans do not exceed 10% of a bank's finance, the BOS encourages the management of the bank to take corrective actions (Bank of Sudan, 1990-2005, Bank of Sudan, 1990-2006).

For banks which have non-performing loans above 10%, the BOS request the bank to prepare a debt recovery plan which should be approved by the BOS. The bank must implement the recovery plan within a month of the approval, otherwise penalties are imposed. If non-performing loans do not exceed 10% of the bank's finance, the BOS encourages the management of the bank to take corrective actions (Hussein, 2003).

5.4 Conclusion

The evolution of Islamic banking in Sudan can be divided into five stages (Ahmed, 2005). The first stage commenced in 1977, when the first Islamic bank, *Faisal* Islamic Bank, was established. By 1983, three more banks opened; *Tadamoun* Islamic Bank, Sudan Sudanese Islamic Bank, and Islamic Co-operative bank. Although these Islamic banks were operating in an environment dominated by traditional banking systems, they achieved high growth in terms of assets, deposits and profitability. The second stage started in September 1983, when the whole financial system started to be converted to the Islamic model. During the conversion period, two additional Islamic banks were established; Al-Baraka Bank Sudan and the Islamic Bank of Western Sudan. This period was characterized by political and environmental crises, which led to structural changes in the country. The third stage started after the down fall of *Nimeiri's* government in 1985 and ended with the military coup of 1989. During this period, many of the traditional banks reverted back to their conventional practices. On the other hand, Islamic banks were forced to operate in an extremely hostile environment characterised by negative media coverage, lawsuits and heavy regulations. The fourth stage started in 1989, when the whole economy was transformed to conform to the Islamic law. The fifth and the final phase started after the peace agreement of 2005 in which the BOS were restructured, during the Pre-Interim Period, so as to reflect the duality of the banking system in Sudan. Two sets of banking system were developed in 2006; Islamic and Conventional.

Some conclusions can be derived from the discussion about the overall performance of the banking system in Sudan. First, the reasonably high growth in

the volume of deposits and increase in the ratio of total deposit-to-GDP over the last years signal a stable confidence in the banking system. The low ratio of credit to GDP 1990-2000 reflects the difficulties SIBs in Sudan are facing providing funds for development. Like wise the finance has witnessed dramatic increase as a number as well as a percent of GDP, deposits and assets. Second, sectoral concentration of investment is not evenly distributed and is biased towards the modern most profitable sectors, including trade, modern agriculture, and industry. Third, the banking has undergone substantial liberalization, privatization and restructuring and increase in bank capital and strengthened its supervision. Moreover, the BOS has been active in the last few years in strengthening prudential supervision and reforming the banking system, tightening the banks' large share of non-performing loans, enhancing profitability, restructuring of banks and increasing the banks' capital, restructuring the loans portfolio, and addressing the difficulties facing them. Lastly, giving these financial performances demonstrated, Sudanese banking finances are not expected to be considered effective for high risk operation nor poverty mitigation and financing micro-enterprises, as its performance and banking indicators are poor.

These last chapters play as foundation chapters in presenting the necessary literature on *musharakah* finance and the performance and history of the Sudanese economy and banking with the objective of contextualising research aim and objectives of this study and its empirical analysis. However, before presenting the empirical chapters, it is crucial to devote the next chapter to the research methodology utilised in the empirical chapters. Hence, chapter six describes the research procedures for data collection both primary and secondary especially the survey questionnaire. It also describes the method of data analysis pursued in empirical analysis. Furthermore, this chapter provides an outline of the research methods used in the fieldwork and presents a description of the study sample and the statistical techniques used to analyse the data as well.

Chapter 6 Research Methodology

6.1 Introduction

The term methodology refers to the overall approaches and perspectives of the research process and is concerned with issues such as collection of certain data; the rationale for the collected data; data collection process and data analysis (Stacey, 1969).

This chapter describes the research procedures for data collection both primary and secondary especially the survey questionnaire, and considers the advantages and disadvantages of this approach. It also describes the method of data analysis pursued in empirical analysis. Generally, the chapter discusses the main issues involved in survey design, data collection and data analysis. Furthermore, this chapter provides an outline of the research methods used in the fieldwork and presents a description of the study sample and the statistical techniques used to analyse the data as well.

6.2 Objectives, Significance and Motivation for Research

The significance of this study stems from the fact that despite the apparent success of Islamic financial institutions in many corners of the world, many governments are reluctant to endorse a full scale shift towards Islamic finance. Limited knowledge about the economic effects of the profit and loss sharing method of the Islamic finance is one of the reasons behind such reluctance. The study hopes to contribute to a better understanding among researchers and policy-makers as to the likely implications of using *musharakah* modes of Islamic finance. Further, this study seeks to provide an empirical investigation of how central bank policies have affected *musharakah* finance over the period 1990-2005 in Sudan.

Hence, this study aims to examine the scope, techniques, policy, and financial performance of *musharakah* (partnership) method used by the Islamic banks. This is expected to produce knowledge quantitatively and qualitatively regarding the activities of these banks so that a better understanding of the fundamental principles of this system can be reached. The study also aims to examine whether the alternative modes of financing and investment operations are successful. Further, the study aims to analyse the main obstacles facing Islamic banks in financing *musharakah* and aims to suggest possible remedies. Also, the study intends to analyse how staff characteristics, bank characteristics and overall environment affect the performance of *musharakah finance* through the banking industry. Specifically, the aim of the study is to closely examine the relations between profitability and risk and banking characteristics.

6.3 Research Method and Design

The specific study designs used by researchers can affect the findings that are produced (Stacey, 1969). There are different research designs in social research, and according to Black (1999) research methodologies can be classified into four categories: historical research, descriptive research, experimental research and developmental-action research. This research is more concerned with a descriptive and experimental approach.

What is going on (descriptive research)? Why is it going on (explanatory research)? The basic difference between descriptive and experimental research is that the former includes observations that have already occurred, hence a researcher measures things as they are (Burns, 2000).

Stacey (1969) states that social research needs a design or a structure before data collection or analysis can commence. For Stacey the major approaches in social science include exploratory research, descriptive research, explanatory research, and evaluation research. Exploratory research attempts to understand some problem or area of study in a preliminary way. Research designs for exploratory research often rely on direct observation of a limited number of examples of what is to be studied. Although exploratory studies do not and are not intended to

provide precise estimates of the prevalence of a problem or to test specific theories, they can be invaluable in mapping domains of study or clarifying the feasibility of specific research strategies and tactics (Stacey, 1969).

Descriptive research usually attempts to examine a few well-developed constructs in detail in an effort to estimate the frequency with which certain behaviours or relevant characteristics occur in a given population (Black, 1999). Descriptive research is undertaken with the objectives to describe relevant aspects of the phenomenon of interest from an individual, organisational, industrial and other perspective. Data collected through descriptive research can provide valuable information about characteristics of the groups and also about the relationships between the characteristics. There are two basic descriptive research studies: cross sectional and longitudinal. The former measures a population at one point in time, while the latter involves data collection at several periods in time (Ragin, 1994).

Explanatory research attempts to investigate the causes of a particular phenomenon, not simply to describe them. Such research carefully tests causal hypotheses. It also rules out rival explanations (Maxim, 1999).

Evaluation research attempts to explore whether a given programme is achieving its stated goals. Process evaluation examines whether the program is operating as planned, whereas outcome evaluation assesses whether the programme achieves the impact or effects that were planned for it (Stacey, 1969).

This research is regarded to be an explanatory research and evaluation research since the researcher is trying to investigate the situation for evaluating. This study uses sample survey as it was thought to be the most suitable way to achieve the research objective especially based on the nature of the data required and the purpose for which it was to be used.

There are two essential methodological approaches to the social sciences; qualitative and quantitative. Quantitative research can be interpreted as a research strategy that emphasises quantification in the collection and analysis of

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data (Black, 1999). By contrast, qualitative research can be interpreted as a research strategy that usually emphasises words rather than quantification in the collection and analysis of the data (Miller, 1983).

In quantitative research, the researcher is ideally an objective observer who neither participates nor influences what is being studied. In qualitative research, however, it is thought that the researcher can learn the most by participating and/or being immersed in a research situation. These basic underlying assumptions of both methodologies guide and sequence the types of data collection methods employed (Maxim, 1999).

Quantitative research readily allows the researcher to establish relationships among variables, but is often weak when it comes to exploring the reasons for those relationships. A qualitative study can be used to help explain the factors underlying the broad relationships that are established (Remenyi, 1998).

For these reasons, the researcher feels that a combination of the literature studies, case studies and a survey investigation approach offers the most appropriate and satisfactory methodology in carrying out this study. The approach of using two or more methods in combination is called triangulation. In social science triangulation is defined as the mixing of data or methods so that diverse viewpoints or standpoints cast light upon the investigated subject (Creswell, 2003). Ragin (1994) argues that one of the principal aims of triangulation in the social sciences seems to corroborate one set of findings with another. Triangulation reduces the risk that a researcher's conclusions will reflect only the systematic biases or limitations of a specific method (Black, 1999). Consequently, the researcher used the quantitative and qualitative approach to analyse the data.

On the other hand, one of the ways research designs can be classified is by the communication methods used to gather primary source data. There are two alternatives; first, the researcher might observe conditions, events or subjects. Secondly, the researcher might survey or question persons about various topics. Furthermore, the researcher wishes to utilize both quantitative and qualitative

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data in our study. This has been necessitated by the fact that for certain issues to be analyzed only quantitative data is available, whereas other concepts have only data of a qualitative nature (Sekaran, 2003). However, the researcher knows that each method has strengths and weaknesses. For example, with primary sources, one collects precisely the information he or she wants. One usually can specify the operational definitions used and can eliminate, or at least monitor and record, the extraneous influences on the data as they are gathered. But secondary sources also have their merits, as they can be found more quickly and cheaply (Crano, 2002).

Both primary and secondary data were used in the preparation of this study. The primary data was acquired through questionnaire surveys, while the secondary data was obtained from library references (books, articles and magazines), published research, related studies, statistical reports, banks annual reports, government and the Central Bank publications and periodical reports. In short, studies made by others for another purpose, represent secondary data. In this regard it is worth mentioning that some data was often available in formats that suit government and banks' planning purposes, but do not cover, broadly, all the information required by this research. This highlights a need for reliable databanks within each sector, to provide complete and standardized information. Time series data relating to macroeconomic performance, monetary and financial aggregates and government policies were obtained from official sources including annual reports of BOS and the economic survey of the ministry of finance as well as other publications.

However, it must be noted that the study only focuses on the perceptions of the investment department employees of the Sudanese Islamic banks. Therefore, it does not include the entrepreneurs' perceptions. In addition the qualitative data will not include any interviews with the investment department employees.

6.4 Data Collection Design

6.4.1 Research Instruments

The most popular quantitative technique is the survey, which can be administered by mail, telephone, face to face, or more recently by the internet (Miller, 1983). In order to collect the appropriate and necessary information for achieving the objective of the study, the questionnaire survey technique was used. It is reasonable to believe that a questionnaire is the most convenient and efficient way to obtain the information needed. The written questionnaire is typically more efficient and practical, and it allows for the use of a large sample (Oppenheim, 2000; Gillham, 2000; Barnett, 1991).

6.4.2 Survey Techniques

As for the main empirical part of this study, the researcher used primary data mainly to suit the nature and purposes of the research which were to elicit respondents' opinions, perceptions and attitudes. The survey approach using questionnaire is thought to be the most appropriate technique in collecting the intended primary data. It also allows quantitative analysis to be conducted in the testing of inferences and also its potential to generalise the findings (Ryan, 2002). A questionnaire is a highly structured data collection technique in which each respondent is asked the same set of reformulated written questions, usually within rather closely defined alternatives (Oppenheim, 2000).

Questionnaires are an inexpensive way to gather data from a potentially large number of respondents. Often they are the only possible way to reach a number of reviewers large enough to allow statistical analysis of the results. Questionnaires assist the process of collecting data by asking all, or a sample of people to respond to the same questions (Miller, 1983).

The survey technique has advantages and disadvantages; the advantages of questionnaires include cost effectiveness and ease of administration ease of analysis through computer software packages; access to hard-to-reach

respondents; simple and quick for the respondent to complete and preserve confidentiality; and no interviewer bias (Gillham, 2000; Dubois, 1992). Disadvantages of questionnaires include: not suitable for complex question patterns; data entry is time consuming; errors in completion; and poor quality control due to the absence of the interviewer. The questionnaire can be conducted through posting to the respondents or personally administrated like face-to-face and surveys, telephone surveys, self-administered surveys (mail and drop-off surveys) and more recently the internet through e-mail and the World Wide Web.

The mail survey only requires the researcher to post the questionnaire to the prospective respondents and wait until it is completed and returned to the researcher. On the other hand, using a drop-off survey, the researcher approaches a prospective respondent, introduces the general purposes of the survey and leaves it with the respondent to complete (Oppenheim, 2000). Essentially, the objective is to gain the prospective respondent's cooperation. Normally, the researcher returns on the same day or the next day to collect the completed questionnaire. In this way a researcher can cover a number of survey locations in a single day with an initial drop-off and later collection (Miller, 1983).

This study adopted mainly face to face surveys and some times the drop off questionnaire approach.

6.4.3 The Advantages and Disadvantages of the Selected Survey Techniques

A face-to-face questionnaire is better than a postal questionnaire, because of the difficulties of conducting surveys with any person in Sudan through the post, as it is rejected culturally. One of the problems associated with postal questionnaires is that people simply enter replies in wrong boxes (Black, 1999). Human errors could easily go uncorrected when the respondent is alone (Miller, 1983). Operation of the face-to-face questionnaire as a suitable instrument for data collection is supported by the literature. For example, conventional evaluations of business support measures rely on face-to-face questionnaire

survey of recipient firms in order to establish the direct benefits of policy (Black, 1999).

Hence, a face-to-face questionnaire has several advantages, and a few disadvantages. In a face-to-face questionnaire, the researcher has the chance to explain the questions to avoid any misunderstanding, and people may be more co-operative when all they have to do is talk. In this situation, the researcher and the respondent may feel more relaxed and give more reliable information. In addition, a face-to-face questionnaire minimises the missing answers and errors. Moreover, it helps to create an atmosphere of confidence between the parties, namely the researcher and the respondents. In addition, it gives the respondent the feeling that there is some interest being shown in them and their role in society (Black, 1999).

The main disadvantage of the face-to-face questionnaire is that with a wide geographical area and a large sample it can be very difficult to achieve good coverage (Dubois, 1992). This problem was solved in our study because the researcher only concentrated on the capital Khartoum. The assistance provided by the team of collectors also helped. Other disadvantages of this method are that firms may not be able to recall events belonging to the *musharakah* funds; they might recall but make mistakes; they might not be able to articulate events in the banks due to the large volumes of the projects, and they might seek to deliberately mislead. This problem was solved by setting clear questions in the questionnaire depending mainly on ranking factors.

The drop off technique was used for three reasons (Brannen, 1992): First, it is suitable for collecting data about attitudes and opinions and has been extensively employed in many similar studies. Secondly, the self-administered approach is appropriate for covering a large number of respondent groups and at diverse geographical locations as intended in this study. Finally, by using the self-administered approach the researcher could overcome several constraints of this study such as the unavailability and inaccessibility of information required to construct a sampling frame such as information on customers and depositors of

the banks under study and the limited resources (both time and financial) available.

The questionnaire was given to five survey teams to be distributed, consisting of students of the Business School at Sudan University of Science and Technology which had on-the job training programmes. The team members' task was to distribute the questionnaires to employees and explain the purpose of this study. The researcher initially held a meeting with the team in which he explained in detail each part of, and the actual questions in the questionnaires. In addition, a general instruction sheet was distributed to help in explaining how to deal with different situations which could arise when conducting the survey.

6.5 Survey Structure and Contents

6.5.1 Survey Structure

The researcher has opted to design a closed type of questions rather than open-ended questions in the questionnaire design. The advantage of closed ended questions are that they can be administered with little direct confrontation and the respondent can perform with greater reliability the task of answering the questions when alternative responses are given (Oppenheim, 2000). Close-ended questions are also easier and relatively quicker to answer. In fact, they require no writing and quantification, since they are straightforward (Miller, 1983).

The kind of questions used and the construction of a questionnaire vary according to the type of information required. Thus, the questions have been phrased carefully in order to be certain that the desired information is secured. Many steps were involved in the construction of a questionnaire. The researcher begins with the research objectives, and then goes through the process of preparing the questions.

This allowed the researcher to use appropriate statistical tests in evaluating the empirical findings of the study as to encourage easy response from the various

respondents under study. It also enabled uniformity and consistency throughout the data collection process.

The questions themselves were mostly ranking or multiple choices, in order to cover a wide range of possible responses. Answering these questions should not only be much quicker, but it was anticipated that they should evoke a higher response rate. Some questions were open-ended, so that the respondents were not restricted in the answers or comments they may have wished to make. It was considered that the questionnaire may be too long, but the risk of facing a lack of information made this inevitable.

The questionnaire was originally prepared in English and then translated into Arabic by using the back-translation method with great assistance from an expert who is fluent in both languages. 320 questionnaires were distributed to staff of the Islamic banks and only 250 were returned to the researcher, which are sufficient for statistical reliability. Staff were contacted in their offices, houses and in the front offices of the head office.

6.5.2 Questionnaire Content

The questionnaire was fairly comprehensive consisting of 33 questions, covering a wide range of issues aiming to gauge respondent attitudes towards equity participation characteristics, objectives and obstacles. The questionnaire covered six pages and was separated into 5 parts (see Appendix for a sample of the questionnaire used in this study).

The objectives of the questionnaire were briefly stated on the questionnaire's covering letter, which also stated the confidentiality of all information provided and that such information was to be used for the purpose of the study only. To encourage target groups to participate and respond to the questionnaire the anonymity of the respondents must be guaranteed by not asking respondents to directly identify their organisations.

The questionnaire contains five sections; the first section was designed to gather information about the respondents' personal profile including gender, age, marital status, educational qualification, managerial experience. The second part consists of questions about the bank which the respondents work for. The preference of *musharakah* finance is the title of the third section, in which the respondents had to give their opinions about the factor/s which effect decisions when choosing to fund an entrepreneur using *musharakah* method and factor/s that determine the capability of the customer to be offered finance using *musharakah* method. The fourth section was devoted to the performance and management of the *musharakah* projects. In this section the respondents expressed their opinions about the profitability and risk performance, average age of the *musharakah* projects, interference into the management decision, awareness of the accurate product cost of the partnership projects, commitment to a quality improvement programme for the partnership finance, and satisfied with their banks' performance measurement systems for *musharakah* projects. In the last sections the questions were devoted to obstacles and constraints facing *musharakah* finance including factor/s which cause the weakness of following up projects from the bank, factor/s which cause the non-performing *musharakah*, and obstacles that hinder *musharakah* projects. The respondents were given the chance in the last questions to give any further comments. The questionnaire is concluded with a statement expressing that the identity of respondents will be treated in strict confidence and not revealed in the thesis or any other publications. If a respondent wishes to receive the conclusions of the study, he/she then has to supply his/her contact information.

6.6 Sample Designs and Sampling Process

6.6.1 Population and Sampling Frame

A population is a group of persons, institutions, or events, which are the aggregate of all cases that conform to some designated set of specifications (Gillham, 2000). For instance, the term investment department staff used in this study defines a population consisting of all the bankers, who are working in the investment section of a Sudanese bank.

The sampling frame is the list or other record of the population from which the sampling units are drawn. Note that not all members of the population of interest are included in the sampling frame. The sampling frame may be based on telephone directories, city directories, or membership lists of private organisations (Barnett, 1991).

Currently, the Sudanese banking system consists of one investment bank, one specialized banks, and 27 commercial banks (4 foreign, 2 state-owned, and 21 jointly owned banks). More than 32% of the Sudanese banks branches for the period 1990-2005 are based in the capital Khartoum in which the questionnaire took place. In 2005 the number of the branches based in Khartoum was 187. Based on the extent of engagement in *musharakah* finance and regional representation, a sample of 8 banks and its branches in Khartoum were sampled for closer examination.

6.6.2 Size of the Sample

Different authors tend to give different guidelines concerning the minimum size of the sample. Rao (2000) states that a sample of more than 30 is thought to be a good estimate of the population. For this study the sample was much larger than 30. In addition, the larger the sample the more accurate the research, while increasing the sample size decreases the width of the confidence interval at a given confidence level (Jessen, 1978). According to sample sizes larger than 30 cases and smaller than 500 cases are suitable for most research. In this study, the sample is 250 cases.

In order to minimize the potential random error in the sample selection process, it was deemed proper to consider the appropriate sampling technique and the sample for the study (Population Centre, 1982). The method of data collection for this study was originally planned on the assumption that the ideal sampling frame as identified in any research methodology literature would be accessible to the researcher. In the case of this study, the ideal sampling frame would be the lists of all investment department employees and managers of the Sudanese banks. The availability of such lists would enable the researcher to sample the

population through the use of a table of random numbers which could ensure random sampling and prevent bias. However, developing such an ideal sampling frame would have been almost impossible, as time and resources were the main constraints to this study. Furthermore, to gain access to information on respondents' profiles was another critical issue, since all banks are bound by duty of secrecy.

To overcome some, if not all, of the difficulties mentioned above, the official statistics and general figures obtained from the Association of the Sudanese banks was utilised as the source of reference when determining the sampling strategy. Another strategy adopted was to distribute the questionnaire randomly to employees at the banks' premises using face to face and drop-off self administered methodology.

According to the association of the Sudanese banks the total number of Sudanese bank's (2004) staff was 16000 in 2004, about approximately 7000 working in the capital. Only between 1000 and 2000 are working in the investment department. The number of overall staff for the eight selected banks in Khartoum is around 2500.

Following the technique introduced by Miller (1983) a purposive decision was made on the total size of 200 observations. The researcher started to collect the data from 17 Sudanese banks. Due to the limited amount of data that 5 banks have released and the inconsistency in the data provided by 4 other banks, the researcher had to eliminate 9 banks from the study. The market share of the 8 selected banks is greater than 90% as the research will discuss in the next chapter.

6.7 Pre-testing, Pilot Validity and Reliability

It is regular practice to pre-test the questionnaire with a small sample prior to starting the survey proper, as this minimises the problems that may arise when producing the final draft. Each survey questionnaire presents its own problems and difficulties before it reaches the final draft. Questionnaires have to be

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designed, and tried out, improved and then tried out again, often several times over, until it is certain that they can do the job for which they are intended (Oppenheim, 2000).

Reliability is the consistency of the measurement, or the degree to which an instrument measures the same way each time it is used under the same condition with the same subjects. Validity is the strength of our conclusions, inferences or propositions (Miller, 1983). In short, were we right? Validity could be divided into two types these are; internal validity and external validity. External validity refers to the extent that the results of a study can be generalized, while internal validity refers to the degree to which a study exactly reflects or assesses the specific concept that the researcher is trying to measure. There are several types of internal validity; face validity, content validity, construct validity, predictive validity and concurrent validity (Kalton, 1983). Validity is more important, if a measure has a high validity, it must also have a high reliability. If it has a low validity, it is misnamed and misleading regardless of its reliability (Gillham, 2000).

The real difference between reliability and validity is mostly a matter of definition. Reliability estimates the consistency of measurement, or more simply the degree to which an instrument measures the same way each time it is used under the same conditions with the same subjects. Validity, on the other hand, involves the degree to which you are measuring what you are supposed to, more simply, the accuracy of your measurement. Validity is more important than reliability because if an instrument does not accurately measure what it is supposed to, there is no reason to use it even if it measures consistently (reliably) (Gillham, 2000). It has been widely recognized that reliability and validity of the instrument used can be improved by using this pre-test or pilot study.

As in any survey work the quality of the results depends in large on the quality of the primary data collected from the respondents. Working on this premise, the researcher took all necessary measures to ensure that the data collected was of high quality in terms of accuracy and reliability. In order to check the content

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validity of the questionnaires the researcher has contacted some experts in the field of banking and finance and some academics in Sudan.

The questionnaire was designed with two goals in mind: relevance and accuracy. A questionnaire is relevant if no unnecessary information is collected. Accuracy means that the information is reliable and valid. So the sequence and elicit wording of the questions were designed in such a way as to promote accuracy and informative answers from the respondents. Hence, back to back translation was carried out in which the translated Arabic questionnaire was translated again into English. The two versions of the English questionnaire were then compared.

Efforts were made to make the questions as short and clear as possible to avoid ambiguity, confusion, and vagueness. In addition efforts were made to avoid asking questions that are beyond the respondents' capabilities or knowledge.

The pilot test for this study was conducted between January and March 2004 in Sudan through a convenience sampling procedure. At least three drafts were made before the final draft. The questionnaire in English was piloted by distributing 10 drafts to Durham University postgraduate students. The questionnaire in Arabic was piloted twice in order to make sure that the questions were easily understood. The first test was made by distributing 25 drafts of the questionnaire to some academics at Sudan University of Science and Technology. The second test was made by sending 15 copies of the questionnaire to some senior staff members of Sudanese banks. Amendments were made following these two tests, in order to make the questionnaire clearer. Their comments and opinions provided valuable feedback, especially with regard to the translation from English language into Arabic and the suitability of some questions. Their opinions also gave strength to the final questionnaire. The final format was therefore established according to the maximum feasible amount of testing.

The pilot study was undertaken after correcting the initial draft of the questionnaire. This was to ensure that the testing of the questionnaire achieved its intended objective. Thus, once the initial draft of the questionnaire had been

designed, each question and the questionnaire as a whole was tested and evaluated. One of the main objectives of pilot testing is to refine the wording, filtering, and ordering, and to control the questionnaire length (Population Centre, 1982). In addition, a pilot study is very useful in making sure that the translation of the questionnaire will not lead to any misunderstanding of the questions.

6.8 Fieldwork Training and Briefing

Particular attention was given to the proper handling of the respondents by the enumerators, especially in the identification and field selection of respondents. Accurate recording of the responses (information) is also given sufficient emphasis in order to eliminate the unnecessary non-random bias that may have occurred in the data (Wax, 1971). This was achieved by having a compulsory one day training and briefing session for all research assistants involved. This was because accuracy and reliability of data collected during the fieldwork depended on the quality performance of these research assistants (Johnson, 1975).

The research assistants were thoroughly briefed on the fieldwork techniques, the objectives of the survey, the content of the questionnaires, the handling of the respondents and the research environment. Other efforts made, included meetings every evening to discuss field problems encountered during the day. Experiences in approaching the respondents, asking the questions and pacifying difficult respondents were shared during these sessions. These debriefing sessions also provided some insights into how to assess the data quality and how to interpret the data. The data collection occurred between May and December 2004.

6.9 Response Rate

A visit was undertaken to the Sudan to collect the main field data. The major survey was conducted between March 2004 and December 2004. In general from a total 320 questionnaires distributed, 261 were returned, out of which 250 were

usable (valid and completed), thereby yielding a response rate of about 78%. This response was considered large enough and sufficient for statistical reliability and generalisation (Population Centre, 1982). This high response rate undoubtedly improved validity and reliability of the survey since the greater the response the more accurately it estimates parameters in the population sampled (Pallant 2002). Hence, no further attempt was made to increase the sample. Details of the number of questionnaires distributed and the response rate are summarised in table 6.1.

It should be noted that some of the questionnaires were eliminated because they contained too many missing items or some contradictions in the answers occurred either by mistake or by misunderstanding of the questions which might affect the results of the study.

Table 6.1 Sample Breakdown and Response

	Bank Name	Valid Response	Distributed Questionnaire
1	Shamal Islamic Bank	39	45
2	Savings Bank	39	45
3	Sudanese Islamic Bank	35	45
4	Tadamoun Islamic Bank	32	40
5	Faisal Islamic Bank	31	40
6	Bank of Khartoum	29	35
7	Omderman National Bank	24	35
8	Saudi Sudanese Bank	21	35
	Total	250	320

6.10 Analysing the Data

6.10.1 Software for Data Analysis

Once the questionnaires had been collected and once the data had been entered into the SPSS software and the data file had been checked for accuracy, the next step involved formatting the raw data into a form that could be used to conduct analysis and to test the research hypothesis. The researcher calculates the total scale score as an effective procedure which can be used to manipulate data sets

(Allison, 2002). This results in a new variable at the end of the data set. If any items had missing data, the overall score would also be missing. The created variable, with its full details, was recorded for a clear guide to the study.

The Statistical Package for Social Sciences (SPSS) is possibly the most widely used computer software for the analysis of quantitative data for social scientists (Norusis, 2004). Using this powerful software all data assembled from the questionnaires' data for this research study was defined and entered by the researcher. Because of the nature of the data and research questions, descriptive statistical methods were used. These methods include frequencies, percentage and means, in order to clarify the differences between the different characteristics and performance.

6.10.2 Descriptive Statistics

Once the data is collected, the first step is to describe it using statistical measures such as the mean and median (central tendency), and standard deviation (variation) (Haberman, 1974). The idea is that for a particular item on the questionnaire, the researcher computed the mean value that underscores the respondents' behaviour with respect to the stated research question and/or hypothesis.

6.10.3 Statistical Technique

Choosing the correct statistical technique to analyse data is one of the difficult parts of the research process. When making this selection, a number of different factors have to be considered, such as the type of question, the type of scales, the nature of the data for each variable and the assumptions that must be met for each of the different statistical techniques. Identifying the statistical techniques used in other related studies should also help in choosing the correct one (Jessen, 1978).

There are a number of steps that can help the researcher to navigate through the decision-making process for the questionnaire. First, what questions does the

researcher want to address? Any researcher should write a full list of all the questions, he or she would like to have answered in his or her research. Some questions could be asked in a number of different ways. These alternatives can help to cover each of the areas of interest (Ragin, 1994). Second, what is the nature of each variable? Knowing the level of measurement for each variable is very important. Different statistics are required for variables that are categorical and continuous. Variables may be categorical (also referred to as nominal level data), ordinal data (rankings: 1st, 2nd, 3rd), or continuous (also referred to as interval level data) (Jessen, 1978).

While the description of data gives some information and ideas about the questionnaire, only testing gives a clear answer regarding a given question. The test generally depends on the nature of data at hand (Leach, 1979). The third step is, therefore, to decide the nature of statistical techniques, as to whether a parametric or a non-parametric statistical technique will be used. Testing is critical in statistical analysis. Statistical techniques are classified into two main groups: parametric and non-parametric. Parametric techniques assume that the underlying distribution of scores is normal. In addition, each of the different parametric techniques contains other additional assumptions that must be checked before carrying out the analysis. Only non-parametric statistical techniques are used in this study (Sprent, 2001).

6.10.4 Statistical Tests

6.10.4.1 Chi-square for Independence

The chi-square test for independence is used to determine whether two categorical variables are related. It compares the frequency of cases found in the various categories of one variable across the different categories of another variable (Gibbons, 1976). Two categorical variables with two or more categories in each are needed. The lowest expected frequency in any cell should be 5 or more for the main assumption. In addition, the significant value needs to be .05 or smaller, otherwise the result is not significant (Antonius, 2003). Mainly this test was used in this study to identify the relation and cross-tabulation between

different nominal variables. For example, the test was used to discover the cross tabulation between the preferred mode of finance and the eight sampled banks, to identify which banks prefer *musharakah* finance.

6.10.4.2 Chi-square Goodness-of-Fit Test

The chi-square goodness-of-fit test, also referred to as the chi square test for a single sample, is a non-parametric test employed in a hypothesis testing situation involving a single with nominal and categorical data (Sheskin, 1997). The chi-square test for goodness-of-fit tests the hypothesis that the distribution of the population from which nominal data are drawn agrees with a posited distribution. The chi-square goodness-of-fit test compares observed and expected frequencies (counts). This test is basically the sum of the squares of the differences between the observed and expected frequencies, with each squared difference divided by the corresponding expected frequency. Two values are involved, an observed value, which is the frequency of a category from a sample, and the expected frequency, which is calculated based upon the claimed distribution. Goodness-of-fit tests test the conformity of the observed data's empirical distribution function with a posited theoretical distribution function by comparing observed and expected frequency counts (D'Agostino and Stephens, 1986).

The purpose of Chi-square goodness-of-fit test is to see if the sample comes from the population with the claimed distribution. Another way of looking at that is to ask if the frequency distribution fits a specific pattern. The chi-square goodness-of-fit test has been used to differ between sample characteristics. For example, the result of the chi-square goodness-of-fit test was used to identify reasonable likelihood that the differences in the Islamic finance methods preference in the sample data can be attributed to chance so as to recognize whether these preferences are significant or not.

6.10.4.3 The Friedman Test

The Friedman test is a non-parametric statistical test developed by the U.S. economist Milton Friedman. Similar to the analysis of variance ANOVA

measures, it is used to detect differences in treatments across multiple test attempts. The procedure involves ranking each row (or block) together, then considering the values of ranks by columns (Conover, 1999).

The Friedman test frequently called a two-way analysis on ranks is the nonparametric equivalent of a one-sample repeated measures design or a two-way analysis of variance with one observation per cell. Friedman tests the null hypothesis that k related variables come from the same population. For each case, the k variables are ranked from 1 to k . The test statistic is based on these ranks (Hollander, 1999).

The Friedman test first ranks the values in each matched set (each row) from low to high. Each row is ranked separately. It then sums the ranks in each group (column). If the sums are very different, the p value will be small. Prism reports the value of the Friedman statistic, which is calculated from the sums of ranks and the sample sizes (Field, 2005). The rank order is particularly important for this study in that it indicates respondents' opinions in terms of their perception of the importance of a specific problem or an issue and their preferred solutions from the alternatives provided. For example, while the respondents were provided with some obstacles usually face *musharakah* finance and were asked to rank them according to their importance. In such a context, this test was used to identify the relevant significant importance of these selected obstacles and to rank their means accordingly.

6.10.4.4 One-way Analysis of Variance (ANOVA)

This is similar to a t-test, but is used with more than two groups to compare their mean scores on a continuous variable. It is called one-way because it measures the impact of only one independent variable on the dependent variable. It compares the variance between the different groups, with the variability within each of the groups. The variance between the groups is given by an F ratio. A large F ratio indicates that there is more variability between the groups. In this case, the null hypothesis that states that the population means are equal can be rejected (Sprent, 2001). Regarding using ANOVA in this research, it was used to

identify any significant differences, for example, in the degree of profitability and risk between different modes of finance including *musharakah*.

All the above statistics are calculated using SPSS that provides the value of the statistic and the critical value *P*. In general; the 5% level is widely accepted as a reasonable level of significance.

6.11 Difficulties and Limitations

It is normal in this kind of empirical research to face difficulties. As for this research, there were some difficulties that the researcher tried to overcome and dealt with appropriately.

Due to the situation in Sudan in the year of the data collection and taking into consideration the information system in Sudan, some crucial parts of the data were difficult to collect. Part of the required secondary data was not properly recorded; some of it was sensitive to share like nonperforming debts and investments. Part of the required data was unavailable. Some respondents were unavailable, reluctant or declined to participate in the survey. Some significant items marked non-response in the survey resulted when some respondents refused to give the answer to particular questions. Some changes in the Sudanese financial system occurred because a dual system (conventional and Islamic) came into effect after the peace agreement was signed which means there is much merit in a new investigation as well as much more data to update.

For the information which is not available through official statistics, the researcher succeeded to seek out other sources to get an idea of the scale and nature of the research problem. The researcher had to go through thousands of files to collect some quantitative data, reaching some bankers was of some difficulty. All these were time consuming.

Due to the above reasons, the data was collected in eight months instead of 3 months as was originally planned. Without the researcher's personal relationship, contacts and network the gathering of research data could have taken even longer. The researcher's personal positive relationship was very important in

facilitating the fieldwork. Indeed, undeveloped civil society plays an important role in people's willingness to respond to questionnaires and interviews (Wax, 1971).

As mentioned earlier, this study is limited to the Islamic banks' employees' perception in Sudan and does not include entrepreneurs' perceptions. In addition, qualitative data assembled for this study does not include any interviews with those employees.

The results of the survey research of this study are generally applicable to the rest of the Sudanese states around the country, based on the fact that the Sudanese society is mostly homogeneous, and any segment of the population should be a fairly accurate representation of the population as a whole. Nevertheless, this study does not claim that the sample is a representation of all *musharakah* projects in other countries. Thus, the study is limited with the experience of Sudan. However, it can be suggested that further research to study other countries are needed to have a comparative understanding of the performance of *musharakah*.

6.12 Conclusion

The methodology employed in this thesis was for obtaining sufficient information to satisfy the basic requirements of the thesis.

In the case of the questionnaire used the number of respondents should prove adequate for interpreting the situation. The final questionnaire benefited greatly from the pilot study, which proved invaluable for framing the appropriate questions. The success of the statistical analysis can be judged from the results obtained in following chapters which should enable the significant variables to be determined and to judge their affects on the wage determinants in the segmented labour market.

Data from Sudan, which fully adheres to interest-free principles of finance, will be used to answer the research questions. Part of the data source is used in the

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previous chapters, the Sudanese banks' balance sheets and annual reports, which provides bank level data for all Sudanese banks for the period 1990-2005. Initially some descriptive analysis is provided. Also, the concentration of *musharakah* in the Sudanese Islamic banks each year is provided so as to give an indication of the influence of *musharakah*. The second part of the data is a survey data collected from the investment department staff working for the 8 selected banks. The survey questions are of nominal and ordinal data. Therefore non-parametric procedures are best suited to this data. A total of 250 of the staff (investment departments' employees only) were randomly sampled. The method of investigation is analytical.

Having presented the research methodology in this chapter, the next four chapters will be devoted for the empirical chapters. The next chapter, (chapter seven), being the first empirical chapter, presents the profile analysis and sample characteristics of the survey and respondents.

Chapter 7 Sudanese Banks' Profile Analysis

7.1 Introduction

It is necessary at this stage to identify the structure of the Sudanese Banks, the geographical distribution of their branches, and the market share of the *musharakah* fund among other finance methods. It is also aimed by this chapter to identify the banks under study and the banks' selection criteria. In addition the official guidelines followed by the selected banks in granting *musharakah* fund are also considered as part of the banks' profile.

The analysis of the Sudanese banks' profile will enhance better understanding of the *musharakah* finance practice and will help to recognise its prospects and obstacles in order to answer the research questions.

Hence, part of the data source used in this chapter is the Sudanese banks' balance sheets and annual reports for the period 1990-2005. Initially some descriptive analysis is provided. The concentration of *musharakah* in the Sudanese Islamic banks each year is provided so as to give an indication of the influence of *musharakah*.

7.2 Structure of the Sudanese Banking Sector

The institutional structure of the banking sector was stable in the 1990s. Table 7.1 shows that the total number of banks was in the range of 25-29 in this period during which two insolvent banks were liquidated, three public banks were merged into the Khartoum Bank to form the largest bank in Sudan, and in 1993 the merger of *El-Neilein* Bank and the Industrial Development Bank created the second largest bank. The *El-Neilein* Bank itself had been sold in 2006. In fact the period after 2000 witnessed the sale of the three governmental banks. Currently, the Sudanese banking system consists of one investment bank, one specialized

bank, and 26 commercial banks (4 foreign, 2 state-owned, and 20 jointly owned banks).

As in many developing countries, the Sudanese financial sector is dominated by a few banks. For instance, the largest two banks, *Omderman* Bank and Bank of Khartoum are government-owned banks with a 25% market share. Those two banks held about 40% of the total banking deposits in 2001 (Kireyev, 2001).

Table 7.1 Structure of the Sudanese Banking Industry 1990-2005

	Total number of banks	State-owned banks	Joint banks Foreign + Local capital	Joint banks Government + private capital	Foreign banks	Specialized banks	Investment banks
1990	28	5	10	2	6	4	1
1991	28	5	10	2	6	4	1
1992	29	4	10	4	6	4	1
1993	29	4	11	5	4	4	1
1994	28	4	11	5	4	3	1
1995	27	2	11	6	4	3	1
1996	27	2	11	6	4	3	1
1997	27	2	11	6	4	3	1
1998	27	2	11	6	3	3	2
1999	26	2	11	5	3	3	2
2000	25	2	11	5	3	3	1
2001	26	2	8	9	3	3	1
2002	26	2	9	8	3	3	1
2003	26	2	9	9	3	2	1
2004	26	2	9	8	3	3	1
2005	29	2	10	10	4	2	1

Source: Bank of Sudan annual reports and Association of Sudanese Banks' annual reports

7.3 Geographical Distribution of Branches

As shown in Table 7.2 there has been a dramatic increase in the number of branches in the 1990s; by the end of 1997 the number of bank branches increased to 695, from 414 in 1990. By the end of 2005 the number of branches increased to 517. The soundness of the banking system has also broadly improved in the last few years, following the Bank of Sudan's comprehensive banking policy, which includes structural and financial soundness reforms and deepening of banking technology and Islamization in the banking system (Ibrahim, 2006). The

cost of establishing branches in the 1990s was high relatively when compared with the 1980s as the inflation rates went up. This made the cost of venturing into branch banking and, therefore, enhancing financial intermediation, higher for banks in these two decades (Ali, 2001).

The massive increase of branches shows that Sudan's banking system had undergone visible changes and this may be in tune with the incessant changes in politics and economic and social policies. It is vital to know these institutional changes before dwelling on the real achievements of the Sudanese banking industry.

Table 7.2 Geographical Distribution of Branches

Year	Khartoum %	Middle %	East %	North %	West %	South %	No of Branches
1990	29	22	13	15	17	4	414
1991	30	21	13	15	17	4	472
1992	27	23	15	14	18	4	576
1993	29	22	14	13	20	3	621
1994	28	22	15	13	19	4	653
1995	30	22	13	13	18	4	648
1996	32	23	14	10	17	3	687
1997	32	23	14	12	16	3	695
1998	32	24	13	11	17	3	686
1999	32	23	14	12	15	3	628
2000	33	22	14	11	17	3	598
2001	33	24	11	11	18	3	572
2002	36	20	13	11	17	3	497
2003	37	21	11	11	17	4	550
2004	34	21	14	11	17	3	526
2005	36	21	14	11	16	3	517
Average	32	22	13	12	17	3	584

Source: Bank of Sudan annual reports, Association of Sudanese Banks' annual reports, and the researcher calculation

Despite the prominent increase in the number of Sudanese banks and branches in the 90s, SIBs are characterized by the regional inequality in the distribution of branches. It is clear that there is a high concentration of branches in commercial towns compared with rural areas, and in the middle including Khartoum, the capital, compared with other regions. From Table 7.2 it may be made clear that the Central States, in which 35% of the population live and which are considered the most advanced States in terms of development projects, infrastructure, per capita income, and standards of living (IMF, 2005), share around 50% of the total banks in the country (Hassan and Hussein, 2003). Moreover, the pattern of distribution has been more or less the same for the last fifteen years or so. Another feature of the SIBs sector is the declining number of branches from over 700 in 1997 to only 533 branches in 2002. This is a distorted geographical distribution of banking facilities, which consequently cannot serve socio-economic development, particularly in rural areas (Ibrahim, 2006).

7.4 Distribution of Funds in Relation to Methods of Finance

In examining the distribution of funds accumulated in Islamic banks according to the methods of finance, this section also aims to find answers to the following research questions:

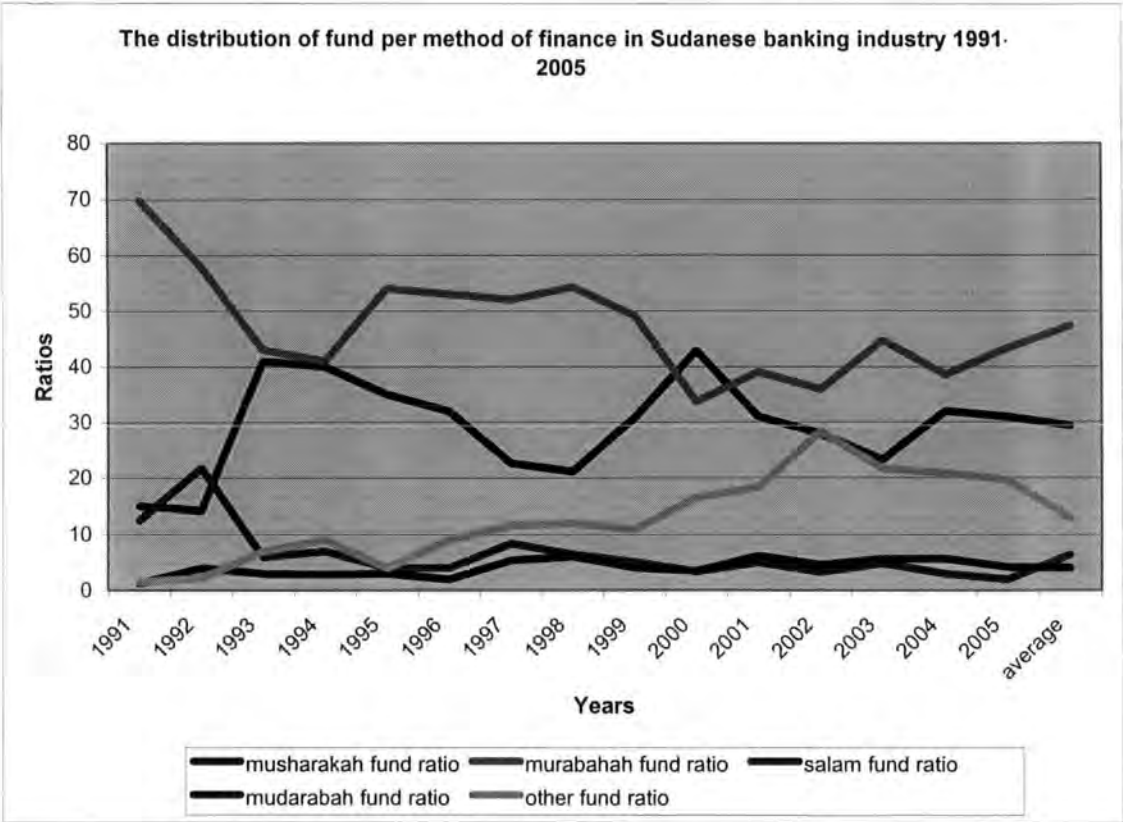
Research Question (1) What is the percentage of musharakah finance among the total Sudanese banking finance?

Research Question (2) Why is musharakah not the priory financial instrument in Sudan?

Figure 7.1 shows the total fund distribution among Islamic finance methods namely, *musharakah*, *murabahah*, *salam*, *mudarabah* and other methods in the Sudanese banks between 1990 and 2005. The trend in figure 7.1 shows that the Sudanese banks prefer *murabahah* over other types of Islamic modes of finance, as *murabahah* had the biggest share of the fund with an average of 47.3% from the overall funds. *Musharakah* is also a popular form of finance among Sudanese banks with an average share of 29.3% of total finance. Due to the increase in non-performing loans in agriculture, banking finance through *salam* contracts

declined from 22% of total banking finance in 1992 to 2% in 2005. Other modes of finance constitute a small fraction of total finance. Remarkably, *mudarabah* has never been of more than marginal importance. On the other hand, there are many reasons why *mudarabah* does not play as large a part as *musharakah*, as *mudarabah* in Sudan works mainly on trade.

Figure 7.1 Islamic Financing in Sudanese Islamic Banks According to Modes of Finance



Mudarabah application is confined only to a small number of well-trusted entrepreneurs with a good track record, usually well known to the financiers. *Salam*, *mudarabah* and other methods achieved on average 6.5%, 4% and 13% respectively. In general, we can notice that there is a gradual increase for *musharakah* fund as it started with 15% in 1990 and increased to 32% in 2004 compared with a gradual decrease for *murabahah* which started with 70% in 1990 and ended with 38% in 2004. In fact in 2000, *musharakah* reached its peak by holding the largest amount of funds, with 43% compared to 33% for *murabahah*.

It must be noted that whilst all Islamic banks and banking operations, all over the world, have been dominated by the non-PLS modes, the share of *musharakah* and *mudarabah* is very low. In Sudan, however, the case is different, as a great increase happened in the PLS share. The share of partnership modes of financing in Sudan, although not satisfactory, are, nevertheless, better than the general trends of Islamic banking compared to other parts of the world, as these formulae constitute less than a quarter of the asset portfolio of the world-wide Islamic banks (Stiansen, 2004). Yousef (1996) has cited that the mark-up techniques shared around 51-60% for Iranian banks and more than that in Pakistan, which like Sudan applies full Islamization of the banking system. However, because the use of *mudarabah* in Iran is bigger, the combination of *mudarabah* and *musharakah* in both Sudan and Iran are almost equal. Yousef (1996) added that the share is in the range of 83-90% for banks in the mixed financial sectors in other countries.

The relative proportions of these different types of Islamic assets will, of course, have implications for a bank's medium and longer term liquidity. The asset structure also has implications for income, with higher income associated with *musharakah* than *murabahah*. The asset structure and composition will also have consequences for bank risk. If problems arise with *murabahah* these will have to be sorted out in a relatively short period or else the asset will be written off. Non-performing assets based on *musharakah* may cause problems for years, and there will be much less pressure to make provisions until the date of maturity of the assets approaches. This, however, means that problems may accumulate ultimately threatening the financial viability of the Islamic bank itself unless appropriate action is taken.

Different explanations have been given for this lack of equity finance. The agency problems, information asymmetric, and moral hazard were among the major explanations for the main unpopularity. Some researchers tried to justify this through highlighting the influence of management and control on the internal governance of the Islamic banks (Tag el-Din, 1991). The moral hazard thesis is however useful in explaining the present financial activities of Islamic banks, namely the dominance of the mark up system. Islamic banks are understood to be

financial institutions based on the profit and loss sharing. However, in practice, while profit sharing is being widely used in the relationship between the bank and the suppliers of funds (depositors), in the relationship between the bank and investment agents (i.e. demanders for funds), it is not very popular. It is the moral hazard problem which explains the general unwillingness of Islamic banks to supply entrepreneurs with funds on the basis of profit and loss sharing.

Khan and Mirakhor (1989) argue, that the shortage of expertise in PLS financing in commercial banks is one of the most important reasons explaining the slow growth of PLS modes of financing in Iran.

Although profit and loss sharing (PLS) modes conform to the real Islamic system of finance which stands contrary to the interest-bearing traditional system they are, nevertheless, not free from application complications. Al-Harran (1993) identified that risk, difficult nature of investment and long-gestation period in receiving returns and problems of management as the major reasons why Sudanese Islamic banks (SIBs) do not undertake equity financing modes. PLS modes require adequate experience in management, additional supervisory and monitoring roles compared with sales-based modes which are relatively less risky and easy to manage. Moreover, PLS modes are subject to erosion of investment in the case of a loss that is why ISBs are hesitant to undertake them at the initial phases of their operations. Instead they use mostly debt-based *salam* and *murabahah* instruments which shift most of the risk to the client. By contrast, Ahmed (2005) has reported that *musharakah* had less risk compared with other modes of finance in two Sudanese banks for the period 1993-1999 while most of the remaining sampled banks were reported to have no difference between their modes performance. However, it is relevant to mention that being exposed to risk, in it-self, is not a reason to reject the business. Even the conventional banks, which work with interest based system, do not advance loans to each and every applicant. They study the risk, the guarantee if needed, and the potentials of the business if relevant. Afterwards, only sound proposals will be approved. Indeed in the case of *musharakah*, Islamic banks have to carry out this study with more depth and precaution then risks management can be developed to minimise the exposed risks and to maximise the expected

profitability (Usmani, 1999). Therefore, it is more likely that over time through accumulated experiences, these banks will be able to develop their own approaches and accept only those projects which fulfil the need of achieving higher profitability. In addition, risk management tools will always contain a diversified portfolio of number of *musharakah* projects as no bank can restrict itself to a single *musharakah*, therefore, it is hardly conceivable that all of these *musharakahs*, or the majority of them will result in a loss. Provided that, some loss occurred can be attributed to chance or luck, the rest will only make a loss if proper measures have not been taken while high returns are expected for exposing more risks, compared with semi profitability guaranteed projects. Hence, if well managed, the possibility of loss for the bank is much less theoretical, or at worst equal, to the possibility of loss in a joint stock company which will be restricted to a limited sector of commercial activities. Notably, the possibilities of loss occurrence have never been a reason for people to stop purchase of these shares. The case of the bank is much stronger, because their *musharakah* activities will be so diversified that any possible loss in one *musharakah* will be more than compensated by the profits earned in other *musharakahs* as mentioned before (Usmani, 2002).

It should also be noted that the Bank of Sudan Annual Report of 2001 admitted that the substantial use of *murabahah* mode of finance in the Sudanese banking system is due to the simplicity of this mode and the people's preference (Bank of Sudan, 2001).

Choudhury (2001) believes that the reason that the PLS is not feasible for funding short-term projects is due to the ensuing high degree of risk (i.e., the time diversification effect of equity). This makes Islamic banks and other financial institutions rely on some other debt-like modes, especially mark-up, to ensure a certain degree of liquidity. This is again not the case in Sudan as most of *musharakah* finance is a short-term finance. Choudhury (2001) further added, the restrictive role of shareholders (investors) in management and, hence, the dichotomous financial structure of PLS contracts make them non-participatory in nature, which allows a sleeping partnership. In this way, they are not sharing

contracts in a true sense; the transacting parties share financial resources without participatory decision-making.

Dar and Presley (2000) believe that the reason behind the lack of PLS modes in Islamic banking practice is because of the fact that PLS contracts are inherently vulnerable to agency problems, because entrepreneurs have disincentives to put in effort and have incentives to report less profit compared to the self-financing owner-manager. But, if this is the case in Sudan, it should apply to both *musharakah* and *mudarabah* modes of financing as well. However, in Sudanese banks as was shown, this is not the case; as Sudanese banks rely on the use of *musharakah* but not *mudarabah*. Furthermore, Dar and Presley (2000) added the imbalance between management and control rights is attributed as a major cause of lack of PLS in the practice of Islamic finance. Given this dichotomy, the agency problem gets accentuated, which may put the PLS at a disadvantage vis-à-vis other modes of financing. The reason for the *murabahah* preference is because of a trading technique, as it is an appropriate instrument, given that most of the finance provided by Islamic banks is directed to trade financing.

Part of the explanation is that PLS financing requires expertise which is not always available. Another reason is that there are no back-up institutional structures such as secondary capital markets for Islamic financial instruments. It is possible also that the tendency to concentrate on non-PLS financing reflects the early years of operation: it is easier to administer, less risky, and the returns are quicker. The banks may learn to pay more attention to equity financing as they grow older.

Ahmed (2005) believes that government pressure has been the major factor behind this shift towards more *musharakah* finance. Two objectives have guided government policy in this regard. One objective has been to reduce what *de facto* was the continuation of interest-based lending through widespread use of synthetic *murabahah* contracts. Another aim has been to increase long-term finance. Some bankers have expressed strong reservations about the Government's preference for the *musharakah* contract, because they see this

contract as much more risky than the *murabahah* that can commonly be secured against liquid assets (Stiansen, 2004).

To conclude, Islamic banks all over the world have shown strong preference for less risky modes of finance, namely the mark up device instead of upholding the fundamental principles of PLS. In Sudan, given that some fifteen years earlier *murabahah* contracts accounted for 70% or more of the total, this is an important change in the cumulative investment profile of the financial sector because *murabahah* contracts are primarily used for short-term deals, while *musharakah* contracts are better suited for long-term investments. Put differently, a *murabahah* contract is particularly well-suited to finance imports and exports, and the *musharakah* is more a vehicle for equity finance (Stiansen, 2004).

7.5 Official Guidelines for *Musharakah* Financing in the Sudanese Islamic Banking Industry

The procedures for *musharakah* investment, are different from one country to another and from one bank to another. However, commonly, the following are the normal procedures usually taken by most of the sampled banks:

7.5.1 Filling out of *Musharakah* Finance Application Form

Each potential entrepreneur fills out a detailed prescribed application form focusing on his/her personal history, knowledge, experience, names of referees, documents, invoices and other certificates required have to be attached e.g. land ownership certificate. All applicants, if relevant, have to submit tax and *zakat* clearance certificates. In addition, a full detailed feasibility study of the project should be attached, including nature of the project, location, employment, cost-estimates, expected revenue and profits as well as the contributed amount requested and collateral provided if any.

7.5.2 Screening of Application Form

The bank examines the application in the light of established prudent banking practices after careful consideration of customer risks through a customer's previous dealings with the bank and his/her current management status, expertise, record keeping, etc. are given due importance in the screening process. The following is part of the screening process:

- (i) Investigation will be carried out into the background of the entrepreneur and assessment of his ability to run the project successfully;
- (ii) The technical, economic and social feasibility of the project will be studied;
- (iii) The projects should be compatible with Islamic *shari'ah* law;
- (iv) Providing licence requirements if needed;
- (v) A staff member may make an inside visit to the project to confirm the information provided concerning assets and capacity e.g. visiting an agriculture scheme and writing a comprehensive report. Full consideration will be given to the feasibility study provided to calculate the turn over in *musharakah* trade, profitability and risks;
- (vi) An interview may be conducted with the customer for any further information needed;
- (vii) If found feasible, then careful consideration will be given to make sure of the compliance of the project file with the investment policy adopted by the bank, the branch if any, and the finance policy issued by the central bank.

7.5.3 Recommendation, Decision and Determination of Profit-Sharing Ratio

If the proposal sounds well in terms of what has been mentioned then the investment department officer will make his recommendation to the head of the department who will make his recommendation to the head of the branch

(Ibrahim, 2004). The branch manager decides whether to accept or reject the application.

Funds and finance which may come under the financial powers of the branch managers shall be approved locally, otherwise the application sent to the headquarters to be studied and evaluated by the investment section who submit a note for final approval by the management. It should be noted that the branch manager's capacity to approve short term finance is different from one bank to another and from one branch to another. Generally, the power of the branch manager is restricted by a specific amount of finance per transaction. Before making an offer, an interview with the entrepreneur may be conducted for negotiation especially to determine capital invested and profit and loss ratios including the management share of the profit which once determined, will not be alterable (for most of the banks). Those are determined on the basis of profit projection compatible with the entrepreneur's past and future expected performance. The portion of profit payable to the entrepreneur, as an exchange of management efforts, will be subject to achieving the level of profit projected by the entrepreneur.

7.5.4 Signing a *Musharakah* Contract

Every bank has a standard typical *musharakah* contract approved by the bank's *shari'ah* compliance committee and the national *shari'ah* compliance committee¹. A typical *musharakah* contract usually contains the following character; it is written in third person, past tense. The date may be mentioned in the beginning or at the end. The two parties are described by name, profession, legal capacity and place of living. The purpose of the investment is explained,

¹ The organizational structure of the Sudanese banks includes the following: First, the board of directors is usually composed of ten members and is the top level of authority. They are elected by the general assembly for a specified period. Second, an administrative committee from within the board members assists it, and is usually composed of three to four members who make decisions about urgent matters that need a level of authorization greater than that of the general manager. Third, the general manager is responsible for the implementation of the plans and achieving the determined goals. Fourth, the *shari'ah* committee is responsible for *shari'ah* compliance. This committee reports directly to the board of directors. Fifth, the deputy general manager, about an average of eight department managers, and a manager for every branch and the various rank levels of staff members assist the general manager.

and its duration. It is then stipulated that any profit "that God may allow" is to be divided according to an agreed percentage. Then the purpose of writing the contract is stated in a variety of formulations. The document is signed by the two parties. In addition, the most common clauses and stipulations may be summarised in the following way:

- (i) The identity of the customer and his legal capacity (that he is sound of mind, mature and acting of his free will and under no duress) is spelled out in standard phrases, either in the beginning of the contract or after his acknowledgement;
- (ii) The customer acknowledgement, *iqrar*, in which he declares he will sincerely work for the partnership and he will do no harm to it and will do his best to achieve the high profit for both parties. And no use of the partnership capital for an outside operation will be allowed as well as acknowledgement of his obligations and duties to the partnership;
- (iii) The description of the partnership, purpose, type of currency and its amount;
- (iv) The date for commencing and finishing or winding up the partnership;
- (v) Capital invested, profit and loss ratios, management share of the profit;
- (vi) Reference to the purpose of writing the document. Reference to God as the Best of Witnesses;
- (vii) Signatures of the two parties to the act, customer and the bank.

A copy of a typical contract in English is enclosed in the appendix

7.5.5 Starting the Project and Management Contribution

After the contract, the capital is usually paid in cash and in advance. However, the partner share might be in kind (inputs) e.g. rent of machines or equipment, in which the assets of the project are a mixture of liquid (non-monetary or even in instalments) and non-liquid assets. This happens when one partner or more cannot provide any cash while he affords to provide his share in a fixed asset or

raw material form, while the rest of the capital is still liquid (Ibrahim, 1999). Also, he or she is rewarded for his/her entrepreneurship, since in relatively profitable ventures the return on investment is much higher than other modes of finance (Abdalla, 1997). Co-ordination between the entrepreneur and the bank staff should be maintained during all stages of project implementation. In practice labour, skills, management, goodwill, credit-worthiness and contacts are provided mainly by entrepreneurs (Thomas, 1995).

In general the following rules are valid (Al-Harran, 1995)

- (i) Every partner is an agent for the other, as all the partners benefit from the *musharakah* business;
- (ii) Every partner enjoys equal rights in all respects in the absence of any condition to the contrary;
- (iii) Any condition regarding participation in and administration of the *musharakah* and variation in the share of profit on this ground is valid; and
- (iv) Every partner has a right to participate actively in the affairs of *musharakah* if he wishes.

If *musharakah* has been formed in a limited liability company form, banks can exercise the voting rights corresponding to their share of the firm's equity capital. Their representatives can sit on the firm's board of directors. Otherwise, if it has been in a partnership form, the bank contributes to the management and decision making with one or two partners. Each partner represents both the partnership and partners and he or she, therefore, enjoys a legal capacity to act for himself and on behalf of other partner(s) in dealings with partnership matters. As far as *musharakah* is concerned, the bank has to participate in the management of the projects. If it was a matter of a small number of projects, the bank may be able to participate in the management of enterprises. But to participate in the management of an infinite number of projects, which is required by the *musharakah* contracts, is certainly highly inconvenient. Even if it is considered convenient, it must involve an additional cost for the bank.

Therefore, in practice most of the management activity especially the day to day management is left to the entrepreneur.

7.6 The Bank Selection Criteria

Since the researcher is looking for banks which entrepreneurs usually select to apply for *musharakah* finance, it is important to know the criteria for the banks selection by entrepreneurs. Many studies have investigated the bank selection criteria or the reasons on the basis of which entrepreneurs choose to bank with specific banks. These studies have identified a number of such factors: convenience (i.e. the location), friends' recommendations, reputation of bank, availability of credit, competitive interest rates, friendliness of bank staff, service charges, adequate banking hours, availability of ATM, special services and the quality of services on checking accounts. The relative importance of these factors varies from one country to another depending upon the age, gender, income, marital status, occupation and cultural background of customers as well as the type of bank Islamic or conventional. (Naser and Al-Khatib, 1999).

Table 7.3 depicts the frequencies and percentage distribution of the banks which the respondents work for.

Table 7.3 Respondents' Employer Banks

Banks	Frequency	Percent
<i>Shamal</i> Islamic Bank	39	15.6
Savings Bank	39	15.6
Sudanese Islamic Bank	35	14.0
<i>Tadamoun</i> Islamic Bank	32	12.8
<i>Faisal</i> Islamic Bank	31	12.4
Bank of Khartoum	29	11.6
<i>Omderman</i> National Bank	24	9.6
Saudi Sudanese Bank	21	8.4
Total	250	100.0

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In our sample the respondents sampled represent all Sudanese banks, both governmental and non governmental (private), large and small scale, old and new, and specialized and non specialized (commercial) banks. The table shows that three of these banks are government banks, notably *Omderman* National Bank, Savings Bank and Bank of Khartoum. These three banks are represented by 36% of the sample while the 64% representing the five private banks are *Shamal* Islamic Bank, Sudanese Islamic Bank, *Tadamoun* Islamic Bank, *Faisal* Islamic Bank and Saudi Sudanese Bank. Additionally, 15% of those respondents are working for a specialized bank, the Savings Bank, in contrast to the other seven banks which are commercial banks. The table also shows that for each of the following, *Shamal* Islamic Bank (a private relatively new and small scale bank), the Savings Bank (a relatively old and large scale bank) and the Sudanese Islamic Bank (a private old and large scale bank) the respondents range from 14% to 15.6% working in each bank. Whereas for *Tadamoun* Islamic Bank (an old, private and large scale bank), *Faisal* Islamic Bank (an old, private and large scale bank) and Khartoum Bank (an old governmental and large scale bank) the respondents range from 11.6% to 12.8% working in each bank, the rest of the respondents, 20% are working for *Omderman* National Bank (a relatively new and small scale governmental bank) and the Saudi Sudanese Bank (a relatively old and small scale bank) as the percentage for each is nearly 10%. This sampling is justified, as the majority of these banks are reported to be using an average of 47% of their funds to finance customers using *musharakah* for the period between 1993- 1999 (Ahmed, 2005).

Moreover, the largest two banks in Sudan are included in the sample namely *Omderman* Bank and Bank of Khartoum with a 25% market share. These two banks hold about 40% of the total banking deposits (Kireyev, 2001).

The researcher may conclude that the sample represents the entire population of the Sudanese banking industry and its component governmental and non-governmental (private) banks, specialized and commercial banks, as well as large and small scale banks and older and relatively new banks.

7.7 Profile for the Sampled Employer Banks which the Respondents Work for

7.7.1 Bank of Khartoum

Bank of Khartoum is the largest and pioneering bank in Sudan. The bank was established in 1913 as 'Anglo- Egyptian Bank' and was the first bank in Sudan. In 1925 its name changed to Barclays Bank then was renamed as Barclays Bank D.C.O in 1954. In 1970 the name was changed to The State Bank for Foreign Trade (Bank of Khartoum, 1990-2005). Afterwards, in 1983 certain commercial and development banks belonging to the State were merged in BOK namely Unity Bank and National Export Import Bank and renamed Bank of Khartoum Group. In 2006 the bank was privatised with the authorized share capital of SD 5 billion (Sudanese Dinars). Up to 2001 the bank was owned totally by the Bank of Sudan and the Sudanese Ministry of Finance. The bank has recently undergone a privatisation process, when in 2006 the Government offered 74% of the shares in return for US \$100 million to the Dubai Islamic Bank. As a result all of the departments had been restructured and jobs streamlined. The market share of the BOK branches equal 20% out of all the branches of other banks in the capital, where the major economic activities are concentrated. The bank owns four subsidiary companies (Bank of Khartoum, 1990-2005): National Company for Financial Transactions; trades in the quoted companies' shares as well as promoting shares in case of initial offering, National Company for Hire Purchase; trades in consumer's commodities on hire purchase terms, National Company of Exchange; deals in Foreign Exchange, and National Company for Trade and Service: deals in all types of consignor's commodities as well as import and export.

7.7.2 Omderman National Bank

Omderman national bank is the largest growing bank in Sudan with three digit growth of profit in 2003 and 44% in 2004. Net profits in 2004 were SD1982m (\$7.9m) (*Omderman National Bank*, 1995-2005). Increased capitalisation was indicative of the bank's push to develop both itself and the market. In 2004,

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Omderman placed strong emphasis on technology investments and training. Special emphasis was given to corporate services without neglecting the bank's strength in the retail segment. The judges noted the increasing diversification of *Omderman's* deposit base, with strong deposit growth from expatriates and foreign corporate. Overall, in 2005 deposits of *Omderman National Bank* grew by 46.6% and the bank now enjoys a 32% share of total deposits in the banking sector. The bank owns three subsidiary companies (*Omderman National Bank*, 1995-2005): *Khartoum Trade and Shipping Company*; deals in export and import, *Nasr Housing and Construction Company*; engages in construction, rehabilitation of building, roads and bridges, and supply of local building materials, and *Omsisco International Co*; engages in custom cleaners, carriage, storage and insurance.

7.7.3 Shamal Islamic Bank

Shamal Islamic Bank was established in 1990 with an authorised capital of SDD 5 billion. *Tadamoun Islamic Bank* and *Faisal Islamic Bank* were part of the first share holders together with some northern Sudanese private investors. The bank owns some few small subsidiary companies working in different sectors including agriculture, constructions and trade (*Shamal Islamic Bank*, 1990-2005).

7.7.4 The Sudanese Savings Bank for Social Development

The Sudanese Savings Bank for Social Development is a governmental bank which was established in 1995 to help the poor and provide production tools to small scale producers and the disadvantaged. The authorised capital of the bank is SDD 7 billion (*The Sudanese Savings Bank for Social Development*, 1990-2005).

7.7.5 Sudanese Islamic Bank

Sudanese Islamic Bank was established in 1983, with a nominal capital of US\$20 million. The concept behind establishment of the Sudanese Islamic Bank has

materialized as a natural outcome of the Islamic revival both within and outside the Sudan on the basis of the fact that economic, social and political integration, added to religious tolerance and collaboration. By the end of 1989-90 the paid-up capital was \$16 million. The bank has 50 branches spread all over the country. The bank owns four subsidiary companies: the Islamic Sudanese Company for constructions and real Estate, Alsalama Insurance Company, the Islamic Sudanese Company for Trade and Investment, and the Islamic Sudanese Company for Agricultural Services (Sudanese Islamic Bank, 1990-2005).

7.7.6 Tadamoun Islamic Bank

Tadamoun Islamic Bank was established as a public company with a limited liability in 1983 as a second Islamic Bank in Sudan with the equivalent of US\$20 million as authorised capital which has been boosted to SDD 3 billion in 2003. The bank's total assets and deposits reached SDD 29.1 and 27.9 billion in 2003 respectively. The bank owns 99% of the equity of two subsidiaries *Tadamoun* Real estate Co. and *Tadamoun* Financial Services (Tadamoun Islamic Bank, 1990-2005).

7.7.7 Faisal Islamic Bank

Faisal Islamic bank was established on the 4 April 1977 as the first Islamic Bank in Sudan, in accordance with the temporary act No 9 for the year 1977. On 18 August 1977, Faisal Islamic Bank had been officially registered as a public limited company, under the companies registration act for 1925, to start operations, in May 1978. The Paid Capital is 3 billion (SD) (Faisal Islamic Bank, 1979-2005).

7.7.8 Saudi Sudanese Bank

The Saudi Sudanese Bank is a symbol of Arabian traditions and a gateway to business in Sudan. It was established in 1984 with an authorised capital of US\$20 million, as a gesture to demonstrate and strengthen the strong ties between the Saudi and Sudanese nations. It also encourages commerce between

the Afro and Arab peoples. The share of the Saudi part is 60% and the remaining 40% is owned by Sudanese private investment. The bank has become a powerhouse of financial capability, professional efficiency and adoption of the most recent technology, serving the (Sudanese) economy and community without losing focus on stakeholders' interests. The bank owns two subsidiary companies: The Saudi Sudanese Trade Company and the Saudi Sudanese Company for Agricultural investment (Saudi Sudanese Bank, 1990-2005).

7.8 Number of Staff and Branches for the Sampled Banks

Figure 7.1 shows the number of the staff working for the eight selected banks and figure 7.2 shows the number of staff in the capital. Generally, the numbers of staff in these eight selected banks are in the range of 200 and 600, except the Bank of Khartoum, the biggest bank in Sudan, which has a range of 1000 and 1700 staff. The average staff members for the selected banks, Khartoum bank, *Omderman* National Bank, Islamic Sudanese Bank, *Tadamoun* Islamic Bank, Saudi Sudanese Bank, *Shamal* Islamic Bank, Faisal Islamic Bank and Savings Bank for the period 2000 and 2005 are 1170, 536, 509, 458, 355, 305, 356, and 430 respectively. In general, the number of staff in the Bank of Khartoum and *Tadamoun* Islamic bank decreased compared with the fluctuation which occurred for the numbers of staff members of *Shamal* Islamic Bank, Islamic Sudanese Bank and Savings bank. The rest of the banks have a general trend of increase.

As for the number of staff, as shown in figure 7.2, in Khartoum, Saudi Sudanese Bank and *Omderman* National Bank experienced a steady increase. In general, the bank of Khartoum, *Tadamoun* Islamic Bank and Islamic Sudanese Bank witnessed general increases except in a couple of years compared with Savings Bank which witnessed a decrease in their number of staff. Fluctuation occurred in the *Faisal* Islamic bank's number of staff too.

Figure 7.2 No of Staff Members

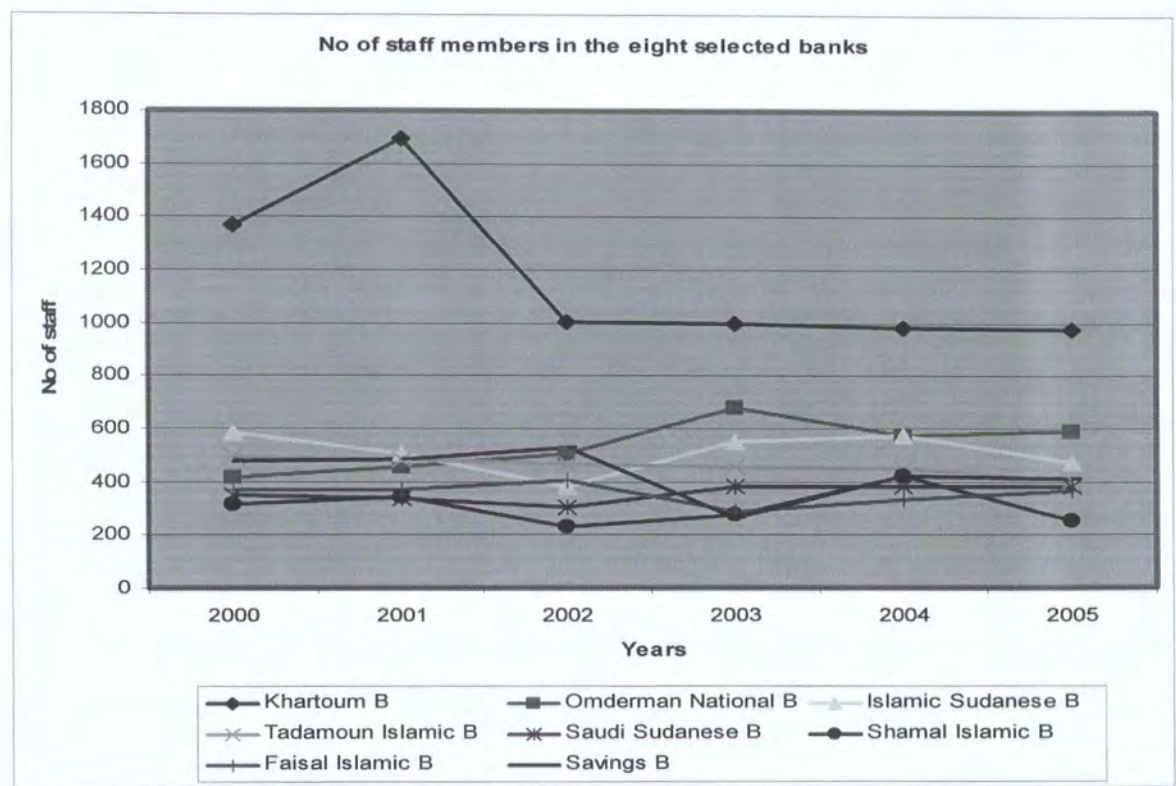
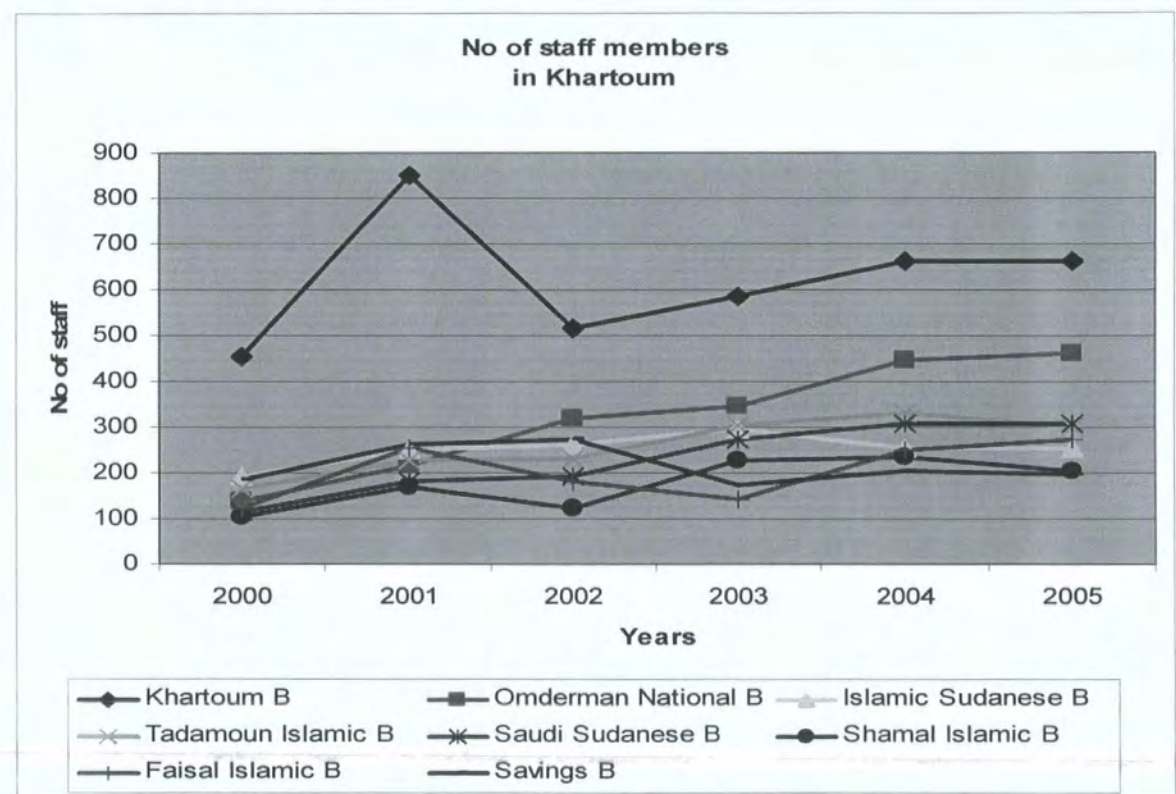


Figure 7.3 No of Staff Members in Khartoum



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The number of branches in the capital Khartoum for these eight banks did not experience a big change as presented by table 7.4. Noticeably, the number of branches for the *Faisal* Islamic Bank and Khartoum Bank are almost equal.

Table 7.4 No of Branches in Khartoum

	Khartoum Bank	Omderman National Bank	Islamic Sudanese Bank	Tadamoun Islamic Bank	Saudi Sudanese Bank	Shamal Islamic	Faisal Islamic Bank	Savings Bank
2000	19	10	12	8	9	11	19	6
2001	19	10	12	8	10	12	20	8
2002	19	10	12	8	9	12	19	8
2003	19	10	12	8	9	12	16	7
2004	17	13	12	8	9	12	19	8
2005	18	13	12	8	9	12	19	8

7.9 Deposits

Table 7.5 depicts the ranking of the eight banks according to the attraction of deposits. *Omderman* National bank maintains its position being the first bank in attracting customers' deposits while Khartoum bank kept its second position throughout most of the period 2000-2005. Saudi Sudanese bank came fourth in 2005. On average, the rest of the banks are placed in the middle of the total list of Sudanese banks.

Table 7.5 Ranking the Banks According to their Deposits

	Khartoum Bank	Omderman National Bank	Islamic Sudanese Bank	Tadamoun Islamic Bank	Saudi Sudanese Bank	Shamal Islamic Bank	Faisal Islamic Bank	Savings Bank	Total Banks
2000	1	3	10	14	12	7	11	15	25
2001	2	1	9	8	11	7	12	14	26
2002	2	1	8	9	7	13	12	14	26
2003	2	1	11	10	6	13	12	14	26
2004	2	1	11	9	5	12	13	14	26
2005	2	1	13	8	4	12	11	14	28

In concluding, after having seen the profile analysis in this chapter, the following empirical chapters are devoted to presenting the survey analysis. These include

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the sample characteristics presented in chapter eight, performance and preference analysis presented in chapter nine and obstacles and constraints presented in chapter ten.

Chapter 8 Sample Characteristics and Analysis of the Opinions of Bank Personnel towards Banking Activities

8.1 Introduction

This chapter, firstly, aims to present the demographic and work related characteristics of the bank personnel who responded to the questionnaire conducted by this study. It is crucial to recognise the demographic details of the respondents, as well as their managerial experience, job level and satisfaction with their financial packages. Hence, this chapter provides information on the personal characteristics of investment department employees in the Sudanese banking industry including gender, age, marital status, education and managerial experience. The questionnaire included a section on respondents' profile as various biographic, demographic and experience factors were likely to influence the answer of the research questions of this study as well as the practice and implications of financing through the *musharakah* method of finance. In order to conduct the data analysis for the primary data, descriptive statistics were employed in this chapter.

Secondly, it also aims to identify *musharakah* management characteristics including the awareness of the product cost and pricing decisions as well as the responsibility and objective characteristics of the banks when carrying out *musharakah* finance projects.

Thirdly, it aims to study the age of *musharakah* projects in which the following two research questions will be answered: what is the average age of *musharakah* projects? and why or why not do Islamic banks prefer short-term *musharakah* finance?

Chapter eight Sample Characteristics and Analysis of the Opinions of Bank Personnel towards Banking Activities

The analysis in this chapter will enhance the understanding of *musharakah* finance practice and will help to recognise its prospects and obstacles, in order to answer the research questions.

8.2 Demographic Information of the Respondents

Table 8.1 provides the frequencies and percentage distribution of personal characteristics of investment departments' employees in the Sudanese banking industry.

Table 8.1 Demographic Profile

	Valid	Frequency	Percent
Sex	Male	224	89.6
	Female	26	10.4
	Total	250	100.0
Age (years)	20 - 30	28	11.2
	31 - 40	146	58.4
	41 - 50	71	28.4
	Above 50	5	2.0
	Total	250	100.0
Marital Status	Single	55	22.0
	Married	195	78.0
	Total	250	100.0
Educational Qualification	Sudan Senior School Certificate	29	11.6
	Diploma	35	14.0
	Bachelor	129	51.6
	Postgraduate	55	22.0
	Other	2	.8
	Total	250	100.0

8.2.1 Gender

As can be seen from table 8.1 the distribution of males and females is uneven. The females represent only 10% of the total sample and 90% of the sample is male. This reflects the representation of both genders in the banking industry in

reality, as females have not joined the industry fully yet. This may be due to the nature of Muslim society where males are expected to carry out the responsibilities of their families; and therefore they are expected to undertake more formal and remunerable work than the women. It is important to note that some Islamic banks like *Faisal* Islamic bank, *Tadamoun* Islamic Bank and *Shamal* Islamic Bank adopted a policy of not employing women. The reasons given in support of this policy relate to both ideology and control. As far as the ideology is concerned, it is understood that Islam is not against the employment of women; however, it implicitly encourages them to stay within the confines of domestic duties. Only in exceptional cases such as the lack of a male provider or in a vocation crucial to the community, may a woman go out to work. It should, however, be noted that the Muslim society has been going through important changes in their social fabric and due to the pressing economic condition, a certain level of liberalisation is taking place regarding women's work.

In order to illustrate the change that has taken place, it is important to state that Islamic banks had a noticeable number of female employees before and after Islamization. However, the control and evaluation of women is considered more difficult than that of men. A woman, it is stated, has to be evaluated due to her physical and emotional differences if management is fair. Culturally, in Muslim societies, a man and a woman doing similar jobs are always treated differently by their superior, as women have always been treated more leniently. Although most managers will at times praise a woman, it is always difficult or impossible to blame or punish her due to the perceived emotional reactions from women. Some even believe that wherever men and women come together in a work setting, productivity is reduced (Ahmed, 1998). As suggested by Ahmed (1998) this is particularly true in a society where males and females are socially segregated. The area of male gender domination needs further study, but this is outside the scope of our research area.

8.2.2 Age and Marital Status

Table 8.1 shows that 58.4% of the respondents belong to the age group ranging between 31-40 years old while the percentage in the 41-50 group is almost 30%. This indicates that the majority of the respondents come from a younger age group.

The majority of respondents (78.0%) were married; which reflects the Sudanese culture that has a tendency towards early marriage. These findings may be attributed to the importance of marriage in Islam (the religion of the majority of the Sudanese), and to Islamic laws, which prohibit sexual relationships outside marriage.

8.2.3 Education and Qualification Level

In general the respondents were well educated. Almost three quarters, i.e. 73%, had a university degree, 51% held a bachelor degree and 22% held a postgraduate degree. The high level of education found in this level indicates the high degree to which employees are informed about finance and banking. This evidence, considered in light of the overall illiteracy rate of about 60% for the Sudanese population over 15 years old (The World Bank, 2005), illustrates that those involved in taking financial decisions are well educated. By contrast, approximately 10% of the employees hold higher secondary school certificates, which is the lowest education level needed to be currently appointed to a position in any Sudanese bank. Therefore, it is possible to conclude that the dominant types of employees are well educated. However, this will not allow us to assume that the same quality will be found outside Khartoum.

8.3 Managerial Experience and Trainings

Table 8.2 provides the distribution of managerial experience and training of investment department employees in the Sudanese banking industry.

Table 8.2 Managerial Experience and Investment Training

	Valid	Frequency	Percent
Managerial Experience (years)	1 - 5	27	10.8
	6 - 10	34	13.6
	11 - 15	112	44.8
	16 - 20	40	16.0
	21 years and above	37	14.8
	Total	250	100.0
Investment Management Experience (years)	Less than 3 years	72	28.8
	3 - 5	65	26.0
	6 - 8	56	22.4
	9 and above	57	22.8
	Total	250	100.0
Investment Training undertaken	Yes	216	86.4
	No	34	13.6
	Total	250	100.0

8.3.1 Managerial Experience

In view of table 8.2, 44% of the respondents had between 11 and 15 years of banking experience combined with 16% and 14% of them who have between 16 to 20 and over 20 years respectively. One can notice that a substantial majority (74%) of the respondents have had over 10 years of banking experience which means that they almost witnessed the whole process of the Islamization of the banking system in Sudan which started in 1992. It can, therefore, be concluded that most of the respondents have relatively long experiences.

8.3.2 Investment Training Undertaken

Table 8.2 also shows that 86% of the respondents have had the chance to be trained to work for an investment department which is responsible for studying, accepting, financing and following up projects financed by the banks using various Islamic finance methods including *musharakah* (partnership). This,

together with the results brought out about the respondents experience and education, point out that the respondents are fairly qualified to manage finance operations including *musharakah* projects and to follow up these projects.

8.4 Respondents' Grade and Number of Supervisees Working under their Direct Supervision

Table 8.3 presents the frequencies and percentages distribution of respondents' job level and number of supervisees.

8.4.1 Number of Employees Working under the Respondents' Direct Supervision

Table 8.3 depicts that most of the respondents are well educated and have relatively good working experience with banks and had the opportunity to be specially trained to work in an investment department. However, the majority of them have less than three employees under their direct supervision, which indicates that promotion in the banking system, will not increase the number of people working under supervision and that the kind of work, tasks and missions they undertake are not changing when they are promoted.

8.4.2 Job Level

Table 8.3 also shows that the normal distribution of the respondents is among different hierarchy levels, which, further, shows that for all hierarchy levels the respondents range between 5% and 19%. Yet, a substantial majority of the respondents were based between grade 7 (g) to grade 4 (d). Approximately 18% of the respondents are based in both grade 5 and 6, then the percentage decreases when it goes up the grading scale and down to the bottom grades. In other words, the number of employees based in any management level goes down gradually whenever moving from grade 6, which means that these banks increased their employees several years ago at the beginning of the Islamization process (about

10 years in total, 2 years for each level); but after that time they started to decrease their appointments.

Table 8.3 Respondents’ Job Level and No of Supervisees

	Valid	Frequency	Percent
No of people working under respondents’ direct supervision	0 – 2	159	63.6
	3 – 5	45	18.0
	6 – 8	13	5.2
	9 – 11	6	2.4
	12 and above	26	10.4
	Total	249	99.6
	Missing values	1	.4
	Total	250	100.0
Job level	Grade 1 (A)	19	7.6
	Grade 2 (B)	15	6.0
	Grade 3 (C)	20	8.0
	Grade 4 (D)	40	16.0
	Grade 5 (E)	45	18.0
	Grade 6 (F)	46	18.4
	Grade 7 (G)	29	11.6
	Grade 8 (H)	21	8.4
	Grade 9 (I)	14	5.6
	Total	249	99.6
	Missing values	1	.4
	Total	250	100.0

8.5 Financial Packages Satisfaction

Table 8.4 demonstrates the frequencies and percentages of respondents’ satisfaction with salary and incentives.

Table 8.4 Satisfaction with Salary and Incentives

	Valid	Frequency	Percent
Respondents' satisfaction with salary and incentives	Yes	47	18.8
	No	129	51.6
	To some extent	74	29.6
	Total	250	100.0

Despite the fact that the respondents are well educated and have good work experience, most of them (51%) are not satisfied with their current salary and incentives as demonstrated by table 8.4., which also shows that only about 18% of them are positively satisfied and 29% to some extent satisfied. This may be a sign of a real need to review the salary and incentive systems to work towards improving the work environment. It can be argued that it is normal to have such results especially in Sudan, where low incomes are somehow a norm. Furthermore, it might be said that any respondents are expected to express their dissatisfaction with their salaries. Nevertheless, such a majority of dissatisfaction should be taken for further study in order to improve the working environment as a first step to improve managerial efficiency in the banking industry as a whole. Additionally, improved working conditions are expected to attract more efficient employees which will increase the customers' trust in the ability of the banking system to manage their deposit's risk. This will also increase the amount of deposits. Furthermore, these steps will increase the profitability of the bank leading to high returns for shareholders and depositors.

8.6 Identifying Differences between the Eight Sampled Banks in Some Selected Factors

Table 8.5 depicts the results of cross tabulation between the sampled banks and some selected variables.

Table 8.5 Cross Tabulation and Chi-square Tests for the Sampled Banks against some Selected Factors

Factors		Value	Asymp. Sig. (2-sided)
Age	Pearson Chi-Square	42.442(a)	.004
	Likelihood Ratio	48.237	.001
	Linear-by-Linear Association	6.307	.012
	N of Valid Cases	250	
Managerial Experience	Pearson Chi-Square	62.844(a)	.000
	Likelihood Ratio	70.137	.000
	Linear-by-Linear Association	3.054	.081
	N of Valid Cases	250	
Satisfaction with Financial Package	Pearson Chi-Square	62.004(a)	.000
	Likelihood Ratio	59.136	.000
	Linear-by-Linear Association	.315	.574
	N of Valid Cases	250	

Table 8.5 shows that there is significant difference between the sampled banks against the respondents' age, managerial experience and satisfaction with current salary since their significance values (0.000) in all factors is smaller than the alpha value of 0.05. This indicates that the level of age, managerial experience and satisfaction with financial package is not the same in all sampled banks.

8.7 Musharakah Management Characteristics

This section intends to discuss the different characteristics of *musharakah* management including the interference in management decisions, sharing the pricing decision, the awareness of the accurate product costs of partnership projects, improvement programmes conducted to improve finance management especially in the management of *musharakah* projects, satisfaction with a bank's methodology for measuring the credit worthiness of the customers, responsibility of the bank in *musharakah* projects, the objective for the Islamic bank to achieve first during its operation, and regulations encouraging using PLS methods of finance.

8.7.1 Awareness of Product Cost and Sharing Pricing Decision with the Customers in Partnership Projects

Table 8.6 Sharing Pricing Decision

		Frequency	Percent
Awareness of the accurate product cost of the partnership projects Chi-Square 129.992 Asymp. Sig. .000	Yes	159	63.6
	No	12	4.8
	To some extent	79	31.6
	Total	250	100.0
The respondents share pricing decisions with their partners Chi-Square 3.848 Asymp. Sig. .146	Yes	97	38.8
	No	81	32.4
	To some extent	72	28.8
	Total	250	100.0

As part of the process, staff must regularly visit the projects and check the bookkeeping, marketing of products, account receivable and collection procedures. These arrangements tend to ensure the safety as well as the profitability of the bank's investment. The bank must constantly watch its interests by focusing on the overall performance of the project, through which a good knowledge of the product's cost and pricing strategy will be gained-investigating for example where losses are made. In such a case the business being supported will be required to provide a satisfactory explanation (Wilson, 1984).

The respondents were asked whether they are aware of the product cost and share the pricing decision. The results are presented in table 8.6. Since the chi-square level is bigger than 0.05 then the null hypothesis will be accepted. Therefore any differences in the respondents' views can not be attributed to chance. In our sample, the employees' awareness of the accurate product cost of the partnership projects is high with 63% of them aware of it because their customers provide them with the necessary information, as well as updating them about market price changes. Only a few of them (less than 5%) are not aware of this, while 38% are to some extent aware of it. Conversely and unexpectedly, with

insignificant chi-square, 38% of them share pricing decisions with their partner while 32% of them do not and 28% to some extent do. This apparent difference can be perceived to be insignificant.

In general, the bank is taking an equity share in the business being supported; it has no interest in sitting on the board of the company or exercising its voting rights at the company or partnership annual general meetings or at any other shareholders' meetings if registered as a separate entity and has no interests in any capital gains if registered as a partnership. Islamic banks maintain low profiles, and are, thus, best regarded as sleeping partners. Referring to most of the *musharakah* cases, the researcher might say that in a substantial amount of these projects the researcher may consider the banks to be indeed sleeping partners. The bank shares in a partnership's profits and is liable for any financial losses. There is no serious problem with this arrangement if the bank is able, and is allowed, to monitor the business operations of the firm. However, proper monitoring mechanisms are yet to be devised for *musharakah* (Ahmed, 2004, Dar and Presley, 2000). Reducing the moral hazard will need a proper follow-up for PLS projects and co-operations between banks and its entrepreneurs. Where there is an ongoing dialogue between the financier and the entrepreneur, business decision-making can be improved, as two parties will be working together to produce a better outcome than when each is working in isolation.

8.7.2 Regulations Encouraging using PLS Methods of Finance

The majority of our sample respondents, as shown in table 8.7, consider their bank's regulations as encouraging the using of PLS methods of finance.

Table 8.7 Regulations Encouraging PLS Finance

		Frequency	Percent
Regulations encouraging the use of PLS methods of finance	Yes	150	60.0
	No	100	40.0
	Total	250	100.0

8.7.3 Improvement Programme

As shown before, in a substantial number of projects staff were neither aware of the product cost nor share pricing decisions with their entrepreneurs. In attempting to see if there are any systematic plans for improvement, respondents were asked to judge whether their banks were committed to a quality improvement programme and their management actively supports the quality programme. The results are presented in table 8.8.

Since the chi-square test shows a level of significance lower than 0.05 then any differences that appear on the percentages of the options given to the respondents is likely true. We can observe that nearly half of the respondents believe that their bank is committed to a quality improvement programme whereas 29% of them believe that to some extent they are committed and 24% do not believe they are committed at all. Therefore, it is can be concluded that the majority consider their banks to be committed to a quality improvement programme regarding their performance.

Almost 60% of respondents believe that their management support their quality programme and in contrast 19% of them believe their management does not, and in the middle, 22% to some extent do. Thus it may seem, when put side by side with previous results concerning commitment to a quality programme, that the respondents believe that there are quality programmes carried out by their banks to improve performance and that their management does commit themselves and support these programmes with a significance level of 0.0.

Table 8.8 Improvement Programmes

		Frequency	Percent
Banks are committed to a quality improvement programme Chi-Square 20.384 Asymp. Sig. .000	Yes	116	46.4
	No	60	24.0
	To some extent	74	29.6
	Total	250	100.0
Management actively supports the quality programme Chi-Square 68.744 Asymp. Sig. .000	Yes	145	58.0
	No	49	19.6
	To some extent	56	22.4
	Total	250	100.0

8.7.4 Performance and Management Decisions Characteristics

The results of the satisfaction with the bank's performance and the interference in management decisions are depicted in table 8.9. It is notable that the p-value (significance or asymp. sig.) is equal to 0.0. As a non-parametric test, therefore, it confirms that the values are not on the same level on all options according to the respondents views. The following can be observed in these differences:

8.7.4.1 Interference into Management Decisions

Table 8.9 Satisfaction with Bank's Performance Measurement

	Valid	Frequency	Percent
The right to interfere in management decisions results in <i>musharakah</i> not being attractive Chi-Square 109.240 Asymp. Sig. .000	Strongly Agree	51	20.4
	Agree	96	38.4
	Uncertain	22	8.8
	Disagree	75	30.0
	Strongly Disagree	6	2.4
	Total	250	100.0
Respondents' satisfaction with their bank's performance measurement systems for <i>Musharakah</i> projects Chi-Square 37.544 Asymp. Sig. .000	Yes	115	46.0
	No	39	15.6
	To some extent	96	38.4
	Total	250	100.0

Since the *musharakah* mode of finance contains a moral hazard that represents the two possibilities of profit and loss which may occur, Islamic banks when using profit and loss sharing contracts try to carefully study the feasibility of this kind of finance. Then, if approved, they manage and follow up these projects as they contain high risk which will lead to more interference in management decisions than other projects and transactions financed using other methods (such as non profit and loss sharing contracts). Consequently, one assumption, which enforces itself effectively here, states that the right to interfere into management decisions results in *musharakah* not being attractive to customers or even to their banks.

The majority of respondents, almost 60%, show their support of the assumption with different kinds of agreements, that is 20% of them strongly agreed and 38% agreed with it. By contrast, 30% of the respondents disagreed with the assumption and only less than 3% strongly disagreed while about 8% of them were uncertain. It can, therefore, be concluded that on the whole most of the respondents suppose the right to interfere into management decisions and this results in *musharakah* not being attractive to customers or their banks.

8.7.4.2 Satisfaction with Performance Measurement Systems

46% of the respondents are satisfied with their bank's measurement systems for the performance of *musharakah* projects; whilst 38% of them are to some extent satisfied and only about 15% of them are not satisfied. Consequently, it may be possible to conclude that a relatively simple majority of the respondents believe that the measurements of *musharakah* performance are quite satisfying and therefore there is no need to proceed further for substantial changes or improvement.

8.8 Responsibility and Objectives Characteristics

8.8.1 The Objective for the Islamic Bank to Achieve in *Musharakah* Finance

The respondents were asked to determine which objective for the Islamic bank should be achieved first during its operation. The Friedman test results, mean rank and mean are presented in table 8.10. The Friedman test was run to identify whether these differences are attributed to chance. The result of the Friedman test chi-square test shown in table 8.11 indicates that there is a reasonable likelihood that the differences between the mean ranks in the sample data can be attributed to chance. The mean confirm the results derived from weighted significance points shown in table 8.10 which can confirm the same ranking mentioned in the descriptive.

The descriptive results indicate that respondents placed highest weight on the contribution to the economic and social development of the country as a first (1.69 mean rank, 1328 points) since 51% of them voted for it while 40% as a first objective and 30% voted for it as a second objective.

Table 8.10 and 8.11 suggest that maximizing the return of the shareholders and depositors is the second important objective with significant points of 1309 and mean rank of 1.76. 40% of the respondents ranked it first which can be compared with 43% and 16% who ranked it second and third. Following them, the customer satisfaction came in third position with a mean rank of 2.66 and significant point of 1086.

Table 8.10 The Objectives for the Islamic Bank to Achieve in *Musharakah* Finance

Factors		Significance					Weighted significance points ¹
		R 1 st	R 2 nd	R 3 rd	R 4 th	Total	
Contributing to the economic and social development of the country	F	129	76	39	6	250	1328
	P	51.6	30.4	15.6	2.4	100.0	
Maximizing the return of the shareholders and depositors	F	101	108	40	1	250	1309
	P	40.4	43.2	16.0	.4	100.0	
Customer satisfaction	F	17	61	163	9	250	1086
	P	6.8	24.4	65.2	3.6	100.0	
Other	F	3	5	8	234	250	777
	P	1.2	2.0	3.2	93.6	100.0	

Table 8.11 Friedman Tests and Mean Ranks for the Objectives for the Islamic Bank

	Mean	Std. Deviation	Mean Rank
Contributing to the economic and social development of the country	1.6880	.82058	1
Maximizing the return of the shareholders and depositors	1.7640	.72554	2
Customer satisfaction	2.6560	.65985	3
Other	3.8920	.45735	4
N 250 Friedman Test Chi-Square 474.456 df 3 Asymp. Sig. .000			

¹ Numbers weighted significance (points) column in the table are the number of votes that each factor received, ranked from 1 to 4. To estimate each factors' significance, the researcher have weighted each vote by points from 4 to 1, 1st rank has 4 points, 2nd rank has 3 points 3rd rank has 2 points 4th rank has 1 points e.g. $129*4 + 76*3 + 39*2 + 6*1 = 1328$.

There is no doubt that poverty in Sudan is wide spread to the extent that incomes cover only a fraction of the cost of living. This is as a result of the relatively low incomes or the inequality of its distribution and the continuous rise in the prices of goods and services. The degree of poverty in Sudan has been measured to be 82.7% and 83.1% for rural and urban populations respectively. Since banks in Sudan are generally commercial and traditional in nature, their credit facilities are only extended to big firms, while their general attitude towards small business is neglected. Access to the official credit system therefore represents a big problem for the small scale entrepreneur. There are neither flexible credit policies for them to acquire funds, nor specialized banks to provide them with credit facilities (Adam, 1997).

Hence, the question arises as to what the Sudanese Islamic banking system of finance to small enterprises can offer to mitigate poverty? In order to see the effects of bank lending to small enterprises upon poverty alleviation, let us concentrate for a moment on the distinction between absolute poverty and relative poverty. Absolute poverty (the inability to meet the basic needs, subsistence needs, in the prevailing socio-economic circumstances) can be a result of sickness, old age, or a continuous increase of prices. Relative poverty, on the other hand, is related to income inequality or as a result of a malfunctioning supply and demand mechanism (Ibrahim and Vijaykumar, 2003).

8.8.2 Responsibility of the Bank in *Musharakah* Projects

The distributions of the percentages of different responsibilities to be carried by the banks during its *musharakah* finance together with chi-square results are presented in table 8.12.

Table 8.12 Responsibilities of Banks in *Musharakah* Finance

		Frequency	Percent
Responsibility of the bank in <i>musharakah</i> projects Chi-Square 234.840 df 4 Asymp. Sig..000	Administrative (solving day to day operation).	80	32.0
	Marketing.	10	4.0
	Providing money only.	130	52.0
	Providing raw material, machinery or equipment.	29	11.6
	Other	1	.4
	Total	250	100.0

Islamic banks are obliged to give priority to the needs of society and the common interest over individual profit and private interest. When the primary concern of the banks is not the maximization of profitability as such, but rather the social imperatives, the tangibility of assets, as a requisite to access to finance loses its importance. Moreover, the granting of credit to an educated, yet financially poor person could be even more beneficial on both social justice and long run growth.

With a significant chi-square, the majority of the respondents (52%) believe their banks should provide money only in *musharakah* projects which means not taking part in other responsibilities like administration, marketing, providing raw material, machinery or equipment. However, 32% of them believe that banks should have administrative duties like day to day operations, 16% of the respondents selected other responsibilities including marketing, providing raw material and machinery or equipment.

It is crucial to state that the selection of providing money comes from a wrong understanding of the nature of *musharakah* finance. *Musharakah* finance assumes that the two partners (bank and entrepreneur) will share the capital and work to achieve the profit. Hence, the understanding of providing money may be the easy way out, but neither does it confirm the Islamic finance principle nor is it the best way to manage the bank risks.

While marketing did not attract the respondents, research conducted about entrepreneurs in agriculture *musharakah* in Sudan showed that 88%, the majority of farmers indicated that they faced marketing problems and the bank did not provide them with enough help (Al-Harran, 1997). It is clear that there are several difficulties facing the customers in marketing *musharakah* products, hence, a recommendation should be proposed for the banks to improve their marketing services provided with its finance.

The Sudanese Islamic Bank has had experience of financing small entrepreneurs and providing them with marketing services as part of the finance package. The goal was to help farmers to fetch good prices for their crop which are often low at harvest time. At that time the bank buys the crop by paying 50% of the obtaining price and stores it under its supervision. When prices rise to some reasonable level, the crop is sold. Of the profits, 50% goes to the farmer by way of management fees while the other 50% is divided equally between bank and partners (Al-Harran, 1995a). Although it is not safe to pass judgement about the feasibility of this practice on the basis of limited information, the evidence of this section supports the contention that the practice is viable and equitable. It is viable for it generates reasonable rates of return for the banks and the legal contract protects their interests (Al-Harran, 1993).

8.9 Average Longevity of the *Musharakah* Projects

This section aims to test the research questions set initially related to the average longevity of the *musharakah* projects. The research questions are as follow:

Research Question (3) What is the average age of musharakah projects?

Research Question (4) Why or why not do Islamic banks prefer short-term musharakah finance?

SIBs usually do not present data relating to the distribution of finance as short, medium and long-term. But, nevertheless, because of inflation, most of the finance, even for agriculture and industry (via provision of raw materials, fixed

assets, working capital, irrigation, inputs, storage, transport and marketing, land preparations, etc.) is short term for a period of a maximum of one year, mainly through *murabahah* and *salam* financing methods. These two modes of finance are suitable for financing short-term projects.

To determine the average age of the *musharakah* finance, the respondents verified the average age of *musharakah* projects they usually finance. Table 8.13 presents the results of chi-square goodness of fit test for the average age of *musharakah* projects together with the distribution of percentages of different periods of projects' ages.

Table 8.13 Average Age of the *Musharakah* Projects

		Frequency	Percent
Average age of the <i>musharakah</i> Projects Chi-Square 458.200 Asymp. Sig. .000	Less than 3 months	9	3.6
	3 - 6 months	181	72.4
	7 - 12 months	50	20.0
	1 - 2 years	8	3.2
	Above 2 years	2	.8
	Total	250	100.0

The result of the chi-square goodness-of-fit test, as shown in table 8.13, indicates that there are differences between the averages of *musharakah* projects' ages. The dominant type of *musharakah* is that which lasts for 3 to 6 months as reflected by 72% of the respondents. Therefore as the researcher mentioned earlier, the reason mentioned by Choudhury (2001) that the PLS involves long term finance which causes a lack of profit and loss sharing finance is no longer valid for the Sudanese case. Choudhury (2001) believes that the reason that the PLS is not feasible for funding short-term projects is due to the ensuing high degree of risk (i.e., the time diversification effect of equity). This makes Islamic banks and other financial institutions rely on some other debt-like modes, especially mark-up, to ensure a certain degree of liquidity. This is again not the case in Sudan as most *musharakah* finance is a short-term finance. Choudhury

(2001) further added, the restrictive role of shareholders (investors) in management and, hence, the dichotomous financial structure of PLS contracts make them non-participatory in nature, which allows a sleeping partnership. In this way, they are not sharing contracts in a true sense; as the transacting parties share financial resources without participatory decision-making.

Part of the explanation is that long-term financing requires expertise which is not always available. Another reason is that there are no back-up institutional structures such as secondary capital markets for Islamic financial instruments. It is possible also that the tendency to concentrate on short-term financing reflects the early years of operation: it is easier to administer and the returns are quicker. The banks may learn to pay more attention to long financing as they grow older.

Al-Harran (1995a) believes that the nature of the short term deposit at Sudanese banks is the main reason for preferring short term finance. He further concluded that if they do not devise non-usurious tools of raising investment deposits, then these banks are likely to face problems in their growth particularly when they are working side by side with the modern banks.

There are three advantages of using short term *musharakah* strategy:

- (i) A broader portfolio diversification, which can reduce risk for a given return or increase return for a given risk;
- (ii) The ability to participate in new risks, including new projects;
- (iii) Rapid capital turnover

These help money circulation as well as allowing for continual re-appraisal of projects. Allowing the banks to engage in risk-return sharing presents them with additional opportunities to diversify their assets, and a bank's asset diversification affects its overall expected net earnings as well as its variance. A more diversified bank represents a more stable source of funds and a more stable place for depositors. Given the desirability of diversification, the banks should be the primary source of determination of the appropriate trade-off between risk and

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return as well as the method of diversification. It is the bank, which has to assess how the various modes of asset acquisition are related in their prospects for timely payment of returns and principal. If the banks are constrained to concentrate their portfolios heavily in favour of one type of asset like mark-up only, then that portfolio must be considered very risky. To discourage banks from engaging in risk-return sharing activities, either through fiscal monetary tools or through institutional constraints such as unfavourable laws, simply because of the perceived risk of these activities, may not be an optimal policy (Mirakhor, 1987). In addition, the lack of popularity of the long term *musharakah* is a reflection of the fact that in an economic climate with negative economic growth and high inflation, no bank (or anybody else for that matter) will commit capital to long-term investment but rather focus on short-term ventures.

Table 8.14 presents the results of the cross tabulation between *musharakah* performance in terms of profitability and risks and the average age of *musharakah*. The results indicate the correlation between *musharakah* risk and the average age of *musharakah* with a significance chi square which states that degree of *musharakah* risk has influence on the average age of *musharakah*.

Table 8.14 Cross Tabulation between Musharakah Performance and Average Age of Musharakah

		Value	df	Sig. (2- sided)
Performance of <i>Musharakah</i> profitability * Average age of the <i>Musharakah</i> Projects	Pearson Chi-Square	7.238(a)	16	.968
	Likelihood Ratio	8.366	16	.937
	Linear-by-Linear Association	.004	1	.952
	N of Valid Cases	250		
Performance of <i>Musharakah</i> Risk * Average age of the <i>Musharakah</i> Projects	Pearson Chi-Square	27.216(a)	16	.039
	Likelihood Ratio	29.199	16	.023
	Linear-by-Linear Association	4.994	1	.025
	N of Valid Cases	250		

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However, almost all the literature states that the PLS supports long term economic and financial development, especially *musharakah* by financing long term productive projects. In reality, nearly all Islamic banks offer trade and project finance *murabahah*, commissioned manufacturing, or on a leasing basis and thus PLS features marginally in the practice of Islamic banking and finance. Whatever the degree of success of individual Islamic banks, the majority have so far failed to adopt PLS-based modes of financing in their businesses. However, the Sudanese banking experience is different, having seen that they succeeded in offering PLS modes, namely here *musharakah*. Yet, these offers are mainly for a short term period of 3 to 6 months.

This study argues that one of the major dilemmas facing the present Sudanese Islamic banks is the fact that these banks have to involve in long term finance according to its theory where these banks mobilize funds on the basis of short term deposits. Facing all the economical and political barriers fronting the country e.g. high inflation rate as external factors, as well as internal factors e.g. small size of capital and lack of managerial efficiency, yet Sudanese Islamic banks have to involve in long term finance. The Islamic banks in many Muslim countries have occasionally used this partnership financing scheme for financing of the working capital of the enterprises for more than one year with considerable success (Al-Harran, 1995b).

Yousef (1996), on the other hand, showed some evidence indicating that ISBs financing is rarely extended on a long-term basis and short-term lending dominates overall. ISBs distribution of finance during the period 1984-1992 was 75.4% short term, 5.4% medium term, 2.1% long term and real estate financing shared 15.4%. If ISBs are not able to generate long-term sizable deposits, they will not be able to extend long-term loans that are deemed necessary to achieve developmental goals (Yousef, 1996).

In fact most Sudanese Islamic funds go to short-term lending and to financing foreign trade (more than 80%). Less than one-third of the short-term credit goes to financing the working capital of industries. For example the Agricultural Bank

Chapter eight Sample Characteristics and Analysis of the Opinions of Bank Personnel towards Banking Activities

of Sudan (now the biggest development bank in Sudan, in terms of capital and number of branches) directs 80% of its loans to relatively short-term credit for medium and large-scale farmers (Bank of Sudan, 1990-2005).

The financing of long-term projects has certain prerequisites. For instance, the Islamic bank will have to identify projects, carry out feasibility studies, estimate expected streams of profits and only then they shall be able to invest in a project. Moreover, they will have to develop a long-term investment strategy (Al-Harran, 1993).

Although all the banks finance short term *musharakah* heavily, notably, not all the sampled banks have the same average age of *musharakah* projects. Table 8.15 shows that the differences of the average longevity of the *musharakah* projects between these banks are significant.

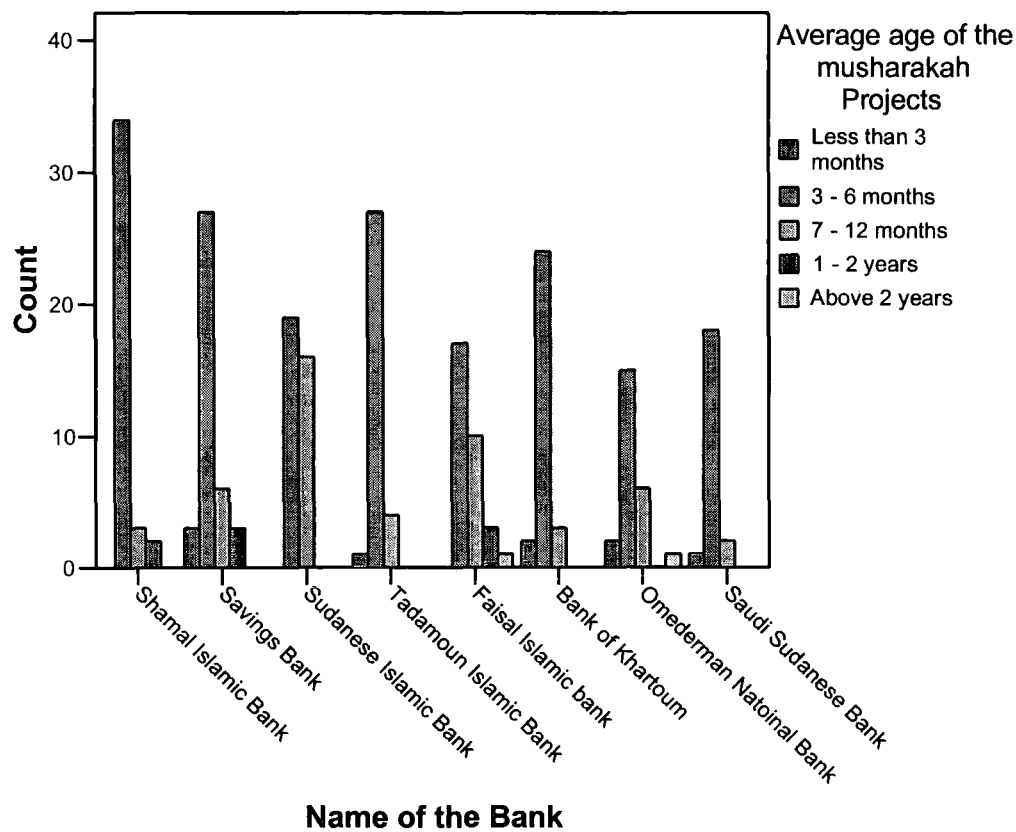
Significantly, this means that the average age of *musharakah* is different from one bank to another.

Table 8.15 Cross Tabulation between the Eight Sampled Banks and the Average Age of Musharakah

		Value	df	Asymp. Sig. (2-sided)
Average age of <i>musharakah</i> projects	Pearson Chi-Square	53.806(a)	28	.002
	Likelihood Ratio	55.973	28	.001
	Linear-by-Linear Association	.352	1	.553
	N of Valid Cases	250		

Figure 8.1 gives illustration to these differences. The figure shows that Sudanese Islamic bank, *Faisal* Islamic Bank and Omderman National Bank finance *musharakah* with a preferred period of 7-12 months more than other banks.

Figure 8.1 Average Age of Musharakah Projects in the Eight Sampled Banks



In concluding, after presenting the sample characteristics in this chapter, the following empirical chapters are devoted to survey analysis. These include performance and preference analysis presented in chapter nine and obstacles and constraints presented in chapter ten followed by conclusion and recommendations in chapter eleven.

Chapter 9 Musharakah Finance in the Sudanese Islamic Banking System: Preference and Performance

9.1 Introduction

The purpose of this chapter is to investigate the preference of the staff of the investment departments at the Sudanese banks in regards to different modes of finance, especially *musharakah* finance as well as its performance.

It is crucial to identify all factors influencing the decision of taking finance through *musharakah* made by the staff of the investment departments at the Sudanese banks. Hence, in this chapter, the preference mode of finance will be analysed, the preferred sector to finance *musharakah* will be determined as well as factors influencing granting credits and hindering *musharakah* investment and factors affecting the distribution of Bank funds according to the different methods of finance. The performance of *musharakah* finance is also crucial. Risk and profitability will be analysed in this chapter.

9.2 The Preference of the Finance Sectors

This section aims to identify the most preferred sector financed through *musharakah*. Therefore, it aims to respond to the following research question:

Research Question (5) What is the preferred economic sector for financing using musharakah instruments?

In order to determine the preferred sector using the *musharakah* mode of finance, the respondents were given five sectors and were asked to rank them starting with the sector they believe should come first in using *musharakah* instruments. These sectors are trade, industry, agriculture, export and import and co operative,

Chapter Nine Musharakah Finance in the Sudanese Islamic Banking System: Preference and Performance

small producers and the craftsmen sector. The mean rank and Friedman test, which shows whether the differences between the mean ranks are statistically significant or not, are shown in table 9.1. The descriptive results are presented in table 9.2.

Table 9.1 Identifying the Preferred Sectors

	Mean	Mean Rank
Industrial sector	2.2280	1
Commercial (Trade) sector	2.6880	2
Export and import sectors	2.8560	3
Agricultural sector	3.2800	4
Co operative, small producers and craftsmen	3.9480	5
Chi-Square Friedman Test 169.117 Df 4 Asymp. Sig. .000		

The analysis in table 9.1 indicates that there is a difference in reaction towards financing different sectors with significance equal to 0.00. Giving that the first important sector was ranked using number 1 and least important ranked using number 6, the industrial sector resulted as the first important sector which should get *musharakah* finance with a mean of 2.23 followed by the commercial sector with a mean of 2.69. The export and import sector came in third place followed by the agriculture sector.

Table 9.2 shows that 27% of the respondents ranked the industry sector as the first important sector compared with 37% ranking it second followed by 22% ranking it third. While 33% of them ranked the commercial sector first, only 18% ranked it second and 14% ranked it third. In addition, the respondents believe that export and import sectors and the agricultural sector are the third and fourth important sectors with 18% and 14% of the respondents, opting for these as the first important sectors, respectively. Lastly cooperative, small producers and craftsmen come last in the ranking. The weighted significance points and the total scores, which are our chosen scheme to identify the overall importance, prove the same results.

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Hence, in answer to the question about the most important sectors, it is the industrial sector followed by the commercial sector. The export and import sector came in third place followed by the agriculture sector. The cooperative and small producers sector came in fifth place.

Table 9.2 The Preferred Sector for Financing *Musharakah*

Factors		Significance					Total	Weighted significance points ¹
		Ranked 1 st	Ranked 2 nd	Ranked 3 rd	Ranked 4 th	Ranked 5 th		
Industrial sector	F	69	94	57	21	9	250	1193
	P	27.6	37.6	22.8	8.4	3.6	100.0	
Commercial (Trade) sector	F	84	45	36	35	50	250	1078
	P	33.6	18.0	14.4	14.0	20.0	100.0	
Export and import sectors	F	46	61	54	61	28	250	1036
	P	18.4	24.4	21.6	24.4	11.2	100.0	
Agricultural sector	F	35	28	64	78	45	250	930
	P	14.0	11.2	25.6	31.2	18.0	100.0	
Co operative, small producers and craftsmen	F	16	22	39	55	118	250	763
	P	6.4	8.8	15.6	22.0	47.2	100.0	

In general, the researcher may divide *musharakah* projects in the Sudanese banking industry into the following categories:

- (i) *Musharakah* sharing of certain financial transactions. In this type of *musharakah* the bank pays up to 40% of the capital of a given project, which is most likely to be an internal trade type project.

¹ Numbers weighted significance (points) column in the table are the number of votes that each factor received, ranked from 1 to 5. To estimate each factors' significance, the researcher has weighted each vote by points from 5 to 1, 1st rank has 5 points, 2nd rank has 4 points 3rd rank has 3 points 4th rank has 2 points 5th has 1 point e.g. $69*5 + 94*4 + 57*3 + 21*2 + 9*1 = 1328$.

This type of *musharakah* is characterised by short-term projects. This type is mainly trade, export and import.

- (ii) *Musharakah* through sharing the operational capital. This type of *musharakah* takes place when the entrepreneur has in his possession an asset, in the form of a company or factory of some kind, but does not have sufficient funds for the day-to-day expenses. The bank provides the customer with financial support for the day to day running of the business, and in return earns a share of the company's profit. This type is mainly used in the industry sector.
- (iii) Diminishing *musharakah*. The bank collaborates with a customer who invests a lesser amount than that of the bank for a certain project. Once this business is up and running the bank takes a larger amount of the profits and as a result gradually gives up its share in the company to its customer. This process continues until the customer becomes the sole proprietor of the business. This type is mainly used in the real estate sector.
- (iv) Continuous *musharakah*: where both parties, the bank and the customer (whose share in the company is usually not below 25%), collaborate specifically for long term projects. The amounts of their capital invested in the projects are reflected by share values, whether in a public or private limited company. This type is rarely used by the Sudanese banks but it can be utilised for different sectors.

In the case of financing the industrial sector through *musharakah*, the Islamic banks provide capital to the owners of the industries, and the owners, on the other hand, contribute with their industry, labour, part of the running expenses and management (Abdel Mohsin, 2005). The industrialist also gets a proportion of the net profit for his management, and the remaining profit is divided between the bank and the industrialist according to their equity share. Through *musharakah* contracts, the Islamic banks succeeded in providing capital to the industrial sector for the purchase of raw materials, machinery and equipment.

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Moreover, the Islamic banks diversified their industrial investments as they entered, as a provider of capital, into different long-term projects. These included food factories, plastic factories, printing presses, drugs factories, spare parts for petroleum refinery, sugar factories, and railway corporations in Sudan. In addition, they enhanced the small-scale industries in Sudan which are believed to play an important role at the present and are a more labour intensive stage of development. The Islamic banks opened specialised branches in one of the biggest industrial areas in Khartoum to develop the handicraft sector (Abdel Mohsin, 2005).

Stated preferences as revealed in this section, however, are not necessarily reflected in actions. The sector which needs more concentration given the Sudanese economy is the agriculture sector. The least sector financed using *musharakah* is the cooperative and small producers; hence, the following section further investigates financing of these three sectors.

9.2.1 Partnership Financing for Trade Finance

This section aims to identify the reasons behind the preference of trade *musharakah*. Therefore, it aims to respond to the following research question:

Research Question (6) Why or why not do Islamic banks prefer musharakah trade finance?

Although table 9.2. shows that the respondents ranked the industrial sector first followed by the commercial sector but in reality these preferences have not been reflected through practice. Trade finance is the sector that gets most of the *musharakah* finance (Bank of Sudan, 1990-2005). The respondents were asked, therefore, to identify the reasons for their *musharakah* trade finance preferences. The results are presented in table 9.3.

Table 9.3 Reasons for Trade Finance Preference

	Frequency	Percent
High profit margins.	87	34.8
The low risk.	32	12.8
The rapid turn over of the capital in trade.	103	41.2
Inadequate capital for other non trading investments.	28	11.2
Total	250	100.0
Chi-Square(a) 69.776 df 3 Asymp. Sig. .000 Mean 2.2880 Std. Deviation 1.06281		

As depicted in table 9.3, with significant chi-square test, 41% of the respondents believe that the rapid turn over of the capital in trade is the reason behind the preference for trade finance while 35% of them refer it to the high profit margins of the trade sector compared with other sectors. Other reasons such as the low risk and inadequate capital for other non trading investments got approximately 10%.

Hence, the main reason behind the preference of *musharakah* trade is the high profit margins of the commercial and trade finance.

The availability of trade finance, particularly in developing and less-developed countries, plays a crucial role in facilitating international trade. Exporters with limited access to working capital often require financing to process or manufacture products before receiving payments. Conversely, importers often need credit to buy raw materials, goods and equipment from overseas. The need for trade finance is underlined by the fact that competition for export contracts is often based on the attractiveness of the payment terms offered, with stronger importers preferring to buy on an open account basis with extended terms as compared to stronger exporters who prefer to sell on a cash basis, or secured basis if extended terms are needed. A number of common trade financing instruments have been developed to cater to this need. Short-term trade finance has been associated with the expansion of international trade in the past century, and has in general been considered as a routine operation, providing fluidity and

security to the movement of goods and services (Auboin and Meier-Ewert, 2003).

9.2.2 Partnership Financing for the Agricultural Sector

One of the most important features of the deepened Islamized system after 1990 was its preference of and special attention to production, especially agriculture. Therefore, attention to the productive sectors went alongside the various reforms in the banking industry. It could be said, therefore, that these continued reforms in the banking system took considerable time from the policy makers (Ali, 1990). The consistent coordination of credit monetary policy with the fiscal and other policies could not have been successfully undertaken had it not been for the continued reforms undertaken in the banking system. Therefore, the Islamization process will continue and improvements in the methods and means applied are subject to revision. The instruments created to control liquidity draw even the attention of the IMF as very novel and creative methods and the *musharakah* formula remains a forceful tool in enhancing development without the cumbersome nature of traditional finance.

However, agriculture finance in Sudan, certainly, saw very high default rates in the 1990s; some bank managers reported that they only recovered about 50% of their agricultural investments. In particular, *salam* contracts were exposed to high risk and a high percentage of non-performing debts. Under normal circumstances, rainfall and other factors that determine production decide whether or not a farmer is capable of servicing his bank obligation. Fluctuations in the weather determined output of the agricultural sector of the Sudan in the 1990s as anywhere else, and in bad years farmers were not in a position to hand over whatever they had sold through a *salam* forward contract (Stiansen, 2004).

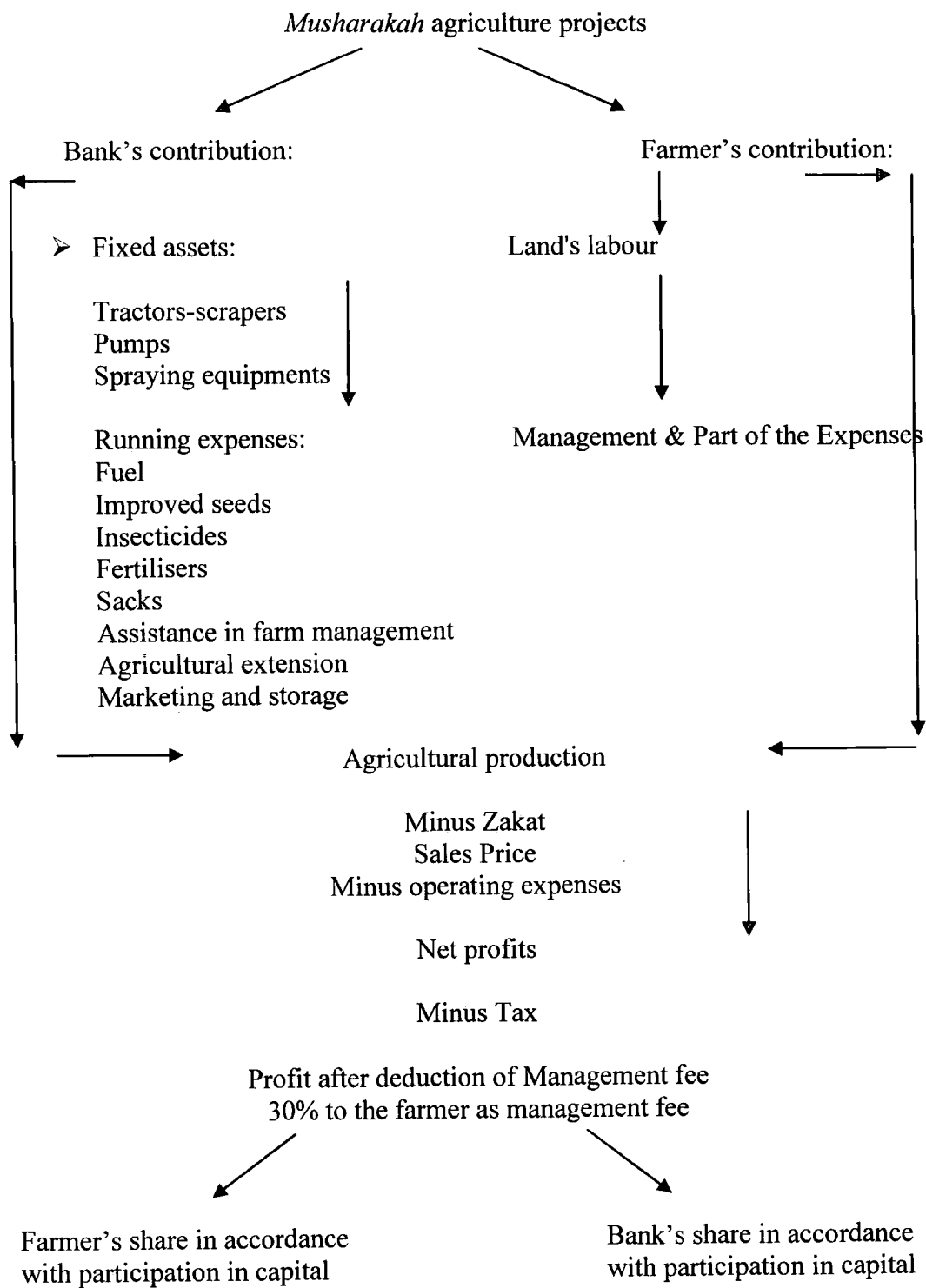
Musharakah was widely used in Sudan in financing the agricultural sector. In this case, the banks provide small farmers with fixed assets such as tractors, ploughs, harrows, water pumps and inputs, e.g. seeds, fertilizers, pesticides and fuel. The entrepreneur, on the other hand, contributes with his land, labour, part

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of the running expenses and management. The farmer gets a proportion of the net profit for his management and the remaining profit is divided between the bank and the farmer according to their equity share (Abdel Mohsin, 2005). The instruments include co-farming, co-irrigation, lease of machinery, and agricultural and marketing services. For instance, SIB executed a number of projects at different places in Sudan with substantial benefits to itself and farmers. The bank provided machinery and other service inputs in these projects, while farmers provided land and operating expenses (Akhtar, 1997).

The Sudanese Islamic bank has excellent experience in financing agriculture through the *musharakah* formula, in which the SIB usually purchases the machinery (tractors, water pumps, spraying equipment etc.) and provides its contribution in the form of services that are complementary to what the farmers provide in a joint effort on the basis of real, not commercial, costs. Usually the SIB provides ploughing and irrigation services, inputs such as improved seeds, insecticide, fertiliser, jute bags (all at cost) delivered to the gate of the farm, working capital, agricultural extension services, storage and marketing, marketing partnership. The farmer's contribution in *musharakah* includes: provision of cultivable land, contribution in the working capital (if available), provision of agricultural labour (which could be the effort of the farmer, his family or those he chooses to hire), and management of the operation jointly with the SIBs (Ali, 1990). Figure 9.1 presents a model for the SIB experience of financing agriculture through the *musharakah* instrument.

Figure 9.1 Model for *Musharakah* Agriculture Finance



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As shown in the figure the farmer nurses the plant until it is ready for harvest. When the crop is collected, it is not sold immediately. This is because at the beginning of the harvest season the prices are usually on the low side. Under normal circumstances, farmers used to sell their crops to merchants who took advantage of the farmers' need for cash after harvest. These merchants purchased the crop at a low price, and they stored it until the price improved and, therefore, became the main beneficiaries of the farmers' effort (Ali, 1990). In this formula, the SIB store the crop after harvest and help the farmer by giving him part of the estimated share of the crop in order to meet his urgent needs. Then, when prices increase, the crop is sold with the knowledge of the farmer and the proceeds are distributed as shown in the figure 9.1. The operating expenses (at cost) and the *zakat*, an Islamic tax, are deducted from the total proceeds. Out of this balance, the farmer is given about 30% of the proceeds for the efforts in nursing the plant and managing the agricultural operation with the SIB. The balance is then divided in accordance with the contribution of each partner in the operating costs. If the farmer contributed 50% of the operating cost (in addition to the land, agricultural effort and management), then the farmer is eligible for 50% of the last balance (Dooren, 1990).

From the SIB experience, and as elaborated by Ali (1990), the farmer obtained 123% of his capital and SIB 109%. The participation of the SIB aimed at starting with the farmer at his current level of technology and gradually making him absorb a higher level of technology. In some cases, SIB has structured a tripartite partnership consisting of a farmer, bank and an expert. The farmer supplies land and labour, and the bank provides working capital while the expert provided management and supervision (Akhtar, 1997). Usually 30% of the net profit is reserved for the expert and the remaining profits are distributed between bank and farmer on an equity share basis.

Local Sudanese Islamic banks are reluctant to use this mode, because of its high risk, since Sudanese agriculture is exposed to high risks such as drought or flood, pests and other threats. Another problem with agricultural *musharakah* is that the prices of agricultural crops fall drastically at the time of harvest. All these, in

turn, lead to poor production, decrease the return on the capital employed or even result in loss. Moreover, this kind of *musharakah* requires close supervision and follow-up, a matter which increases the transaction costs of the bank (Abdel Mohsin, 2005).

However, *musharakah* agriculture finance has proved to be risky, due to bad farming seasons that render most agriculture projects unable to repay the capital, particularly in the absence of a modern means of production to help combat frequent droughts and annual rainfall fluctuations. This is complicated by problems of poor guarantees. Under these difficult conditions it is important to consider the main challenges and risks that face the SIBs and the measures that can be taken to alleviate the problem. Generally, Sudanese banks adopted some measures to tackle the challenges of credit risks in agriculture. These include:

- (i) Delivery of farm financing in instalments according to the actual needs of the crops' growth stage accompanied with frequent visits to the projects receiving financing;
- (ii) Contributing to the establishment of the national insurance company to encourage the establishment of insurance services for farming activities;
- (iii) Participating in the establishment of crop marketing companies to help in marketing crops produced by the project subject of finance such as Sudan Cotton; and
- (iv) More financial training for the staff, especially with regard to proper delivery and collection procedures.

9.2.3 Financing the Co-operative and Small Producers Sector

Wider branch networks and ranges of banking services are a prerequisite for banks in order to reach a large number of entrepreneurs, through partnership formulae. The partnership arrangements can also enhance the ability and incentives of banks to reach small entrepreneurs, thus overcoming the

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commercial banks' reluctance to lend to small producers. Using partnership arrangements, however, does not mean providing finance to small and micro-enterprises on lower rates.

As shown in Chapter 7, the prominent increase in the number of Sudanese banks and branches in the 90s is described and characterized by the regional inequality in the distribution of branches. It is clear that there is a higher concentration of branches in commercial towns compared with urban areas, and in the middle including Khartoum, the capital, compared with other regions. The Central States in which 35% of the population live and which are considered to be the most advanced States in terms of development projects, infrastructure, per capita income, and the standards of living (IMF, 2005), share around 50% of the total banks in the country (Hassan and Hussein, 2003). Moreover, the pattern of distribution has been more or less the same for the last fifteen years or so. Another feature of the SIBs sector is the declining number of branches from over 700 in 1997 to only 533 branches in 2002. This is a distorted geographical distribution of banking facilities, which consequently cannot serve socio-economic development, particularly in rural areas.

Micro-enterprises and small businesses have received little attention from the formal financing system. With the exception of isolated experiences, most of the Sudanese financial institutions have been reluctant to extend credit to this sub-sector. The policies of these institutions, in addition to the macroeconomic policies adopted by the Sudanese Government until recently, were biased in favour of medium and large-scale enterprises. Some reported evidence shows that the partnership financing scheme provides reasonable returns to small entrepreneurs, which help raise their standard of living (Akhtar, 1997).

The lack of a co-ordinating mechanism between the banks themselves and other institutions concerned with small enterprise financing has created another important constraint, together with the lack of national policies especially designed and oriented towards Small and Medium Enterprises SMEs. Recent national policies towards small enterprises and productive families have shown some positive signs. However, the financing policy of 1994-95 for the first time

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specified productive families as being the sectors which need more support (Ibrahim, 1997).

The financing regulations of the Bank of Sudan are still under modification, and lack proper identification of the share of banking finance in co-operative and small producers sector, despite more than seven years having passed since the mid-1990s. In addition, the lack of recognition of female managed small enterprises relates to the understanding of the Sudanese financial institutions that these are only income generating activities rather than commercial, business-like activities. It may also be related to the lack of recognition of female business acumen. This understanding ignores the recent growing phenomenon of female managed small enterprises in Sudan and the role of women as proactive entrepreneurs.

Some Sudanese banks, however, have managed to employ Islamic formulae to finance small producers. So far these banks have fulfilled some expectations in small enterprise financing, though some difficult questions still need to be tackled. These are related to co-ordination, national policies, definition of the target group and the relatively high costs of follow-up (SIB, 1993). There is a lack of a unified definition of small and medium enterprises, SMEs with specified socio-economic characteristics. Moreover, the costs of continuous follow-up and the monitoring of projects are relatively high. To reduce the cost of follow-up, the SIB, for example, have created the small producers and families branches SPFBs to serve limited geographical areas and the bank is thinking of employing a third party to follow-up and share a certain percentage in the total profits.

Among all Sudanese banks, banks like the Sudanese Islamic Bank seem to be the only one to confine the scope of *musharakah* to finance poor families and handicraft. Others appear to be confining the scope of *musharakah* mainly to trading operations excluding private sector imports. In fact law relating to *musharakah* is suggestive of a simple mode of trade vis-à-vis purchase and sale.

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In financing productive families and SMEs, the SIB has the following aims:

- (i) The consolidation of the sense of social justice and solidarity (*Takaful*) among the members of society;
- (ii) Participation in investment in ways that benefit the local community;
- (iii) Promotion of banking awareness;
- (iv) The use of the largest portion of the fund, that is available for investments, in income-generating activities.

Projects financed cover a wide range of small urban enterprises such as tailoring, food processing, shoe and soap making, chalk, cheese-making, goat and poultry-keeping, petty retail trade and some informal sector activities, such as *kisra* (flat local bread) making. Business specialisation varies according to geographical location of the productive families' branches, with the concentration of foodstuffs at al-Thawra branch; sewing at al-Girsh model branch; poultry, cows, and goat keeping at Wad Medani branch. The experience of the Sudanese Islamic Bank has revealed some of the advantages of such non-traditional transactions. None of the partners who are financed could have previously gained access to such funding, had the Sudanese Islamic Bank, especially Productive Families Branches (PFBs) not been available. Ordinary people in urban residential areas, especially women, can get access to conveniently located branches. They can open family savings accounts with a minimum amount and no formalities in withdrawals. The experience helped in such a way to mobilise deposits from a specific geographical location, and finance that money to the same dwellers.

The SIB experiment in financing productive families has also brought with it some innovations in banking on both local and international levels, by establishing branches in the residential areas. This new banking convention has reformulated the bank-client relationship on both the savings and investment sides with regard to regulatory control.

As a result of *musharakah* financing trust is built between the bank and residents of the local community in which the bank operates. This could be further

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capitalised on by launching community based development programmes. One important positive aspect of *musharakah* is that no finance cost is added to the production cost. It can, therefore, contribute to lower prices in comparison to other methods of finance (Abdalla, 1999).

Currently, much of the commercial banks' reluctance for financing small firms and entrepreneurs is due to their lack of bookkeeping, the concealment of actual profits and reporting of losses. A serious effort is needed on socio-cultural, moral, and political fronts to develop a culture of sound and fair business practices. Media and mosque institutions, and political parties can play an important role in developing this culture (Akhtar, 1997). The Government of Sudan should enact a specific law to regulate the conduct of *musharakah* financing. This law should obligate the clients to keep complete accounts of the *musharakah*-financed projects. Banks should have the right to probe the accounts and monitor the project at different stages. Moreover, specific regulations should be enacted to close all possible loopholes for cheating, fraud and concealment.

It is worth mentioning that banks have to work, so as to achieve the best results for its projects, to improve customers' skills in management by conducting training to customers in small business management marketing policies and promotion; and quality and production control.

9.3 Performance Analysis of *Musharakah* Projects

Performance evaluation is an important pre-requisite for sustained growth and development of any situation. It is customary in commercial banks to evaluate the pre-determined goals and objectives, the criteria of revaluation has undergone changes overtime (Sarker, 1999). To get a clear picture of the *musharakah* performance, the researcher investigates the respondents' assessment of its profitability, risk and performance management system for their banks. This section provides information on the financial performance of *musharakah* projects.

9.3.1 Musharakah Profitability

This section aims to investigate the perception of *musharakah* profitability. Hence, it aims to respond to the following research question:

Research Question (7) What is the perceived financial performance of musharakah in terms of profitability?

Table 9.4 depicts the perceived *musharakah* profitability, from which it is notable that the P-value (significance or Asymp. Sig.) is equal to 0.0 for *musharakah* profitability. The non-parametric test, therefore, confirms that the profitability performance is not on the same level on all options according to the respondents views. The profitability of *musharakah* projects is high. As a result, on the whole 45% of the respondents consider the profitability of *musharakah* projects to be high, alongside 22% of them who believe it is very high, while only 8% believe it is low and 33% consider it to have acceptable profits compared with other projects financed with other methods. Accordingly, it can be summed up that the majority of the respondents believe that the projects financed using *musharakah* have a high profitability compared to their banks' standards.

Table 9.4 Musharakah Profitability

	Valid	Frequency	Percent
<i>Musharakah</i> Profitability Chi-Square 190.520 Asymp. Sig. .000	Very High	57	22.8
	High	114	45.6
	Acceptable	76	30.4
	Low or none	2	.8
	Not sure	1	.4
	Total	250	100.0

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Sudanese banks usually use *murabahah* profit margin as a minimum accepted profitability for any *musharakah* application and feasibility study. Meera and Abdul Razak (2005) have suggested market interest rates, such as the LIBOR, BLR etc., as the benchmark for *musharakah* acceptable profitability for any feasibility study. Doing so would make the *musharakah* similar to floating-rate conventional financing, since the mathematical formulas with interest were replaced with rental for the *musharakah* turn out to be similar to the conventional.

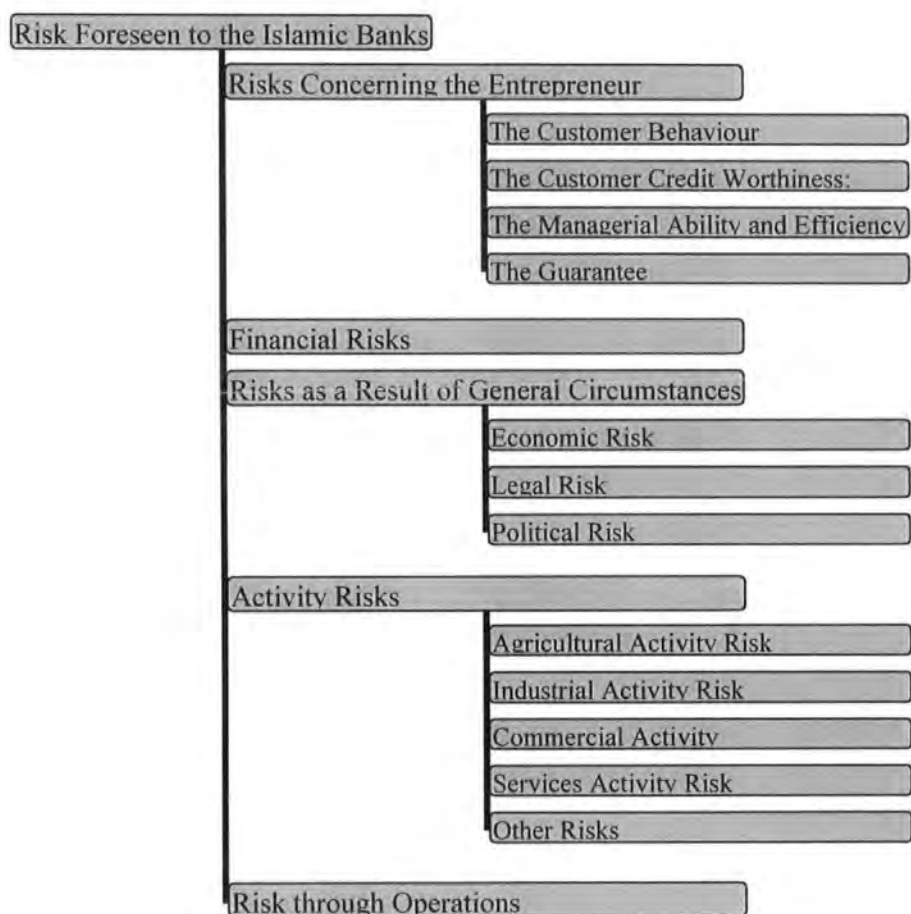
One way to achieve increased profitability is to generate surplus by reducing the cost of finance with fixed revenue, or by increasing the revenue with a fixed cost or to reduce the cost and increase the revenue if both can be manipulated. Since the research will advise more monitoring and following up to reduce risks then minimising cost is not an option. The only choice then is to select high profit projects.

9.3.2 Musharakah Risk

9.3.2.1 Musharakah and the Risks Foreseen by Banks

The *musharakah* involves a degree of risk which depends on the technical and managerial authority granted to the client who becomes a participating partner. The Islamic bank should not require collateral from the other partner(s) and if the bank asks for any guarantees they will be related to the management of the project and the ability of the partner(s) to abide by the legal terms of the contract. As shown in figure 9.2 risks can be divided into three different categories: entrepreneur risks; activity and circumstantial, operational and financial risks.

Figure 9.2 Musharakah Risks Foreseen by the Islamic Banks



9.3.2.1.1 Risks Concerning the Entrepreneur

Entrepreneur risk may arise due to the entrepreneur's behaviour and financial capability, their credit-worthiness, the managerial competence and efficiency of the entrepreneurs, the guarantee offered by entrepreneurs.

- (i) The customer's behaviour: The relevant factors in assessing risk are lifestyle and manners, previous dealings and reputation, credibility and honesty. All of these factors have a significant bearing upon the entrepreneur's behaviour post-loan, on whether he will carry out the agreements entered into, or has signed the agreement without intending to carry it out. Of course the bank would not like to deal with someone whose behaviour is classed as 'bad' (Ahmed, 2006)
- (ii) The entrepreneur's credit-worthiness: The capital offered by the entrepreneur is an indication for the entrepreneur's credit-worthiness. This is found out through publications such as annual reports and shareholders' bulletins. Profitability and liquidity ratios can also give indications of the amount of capital (Ahmed, 2005).
- (iii) The managerial competence and efficiency of the customer: This relates to the customer's dealings with money and operations (Ahmed, 2004).
- (iv) The guarantee: A written guarantee from the customer can solve any of the problems faced by the investment. Such a guarantee needs to be something that is easy to sell and easily convertible to cash. It must be noted here that the guarantee provided in *musharakah* is against mismanagement and negligence as the profit is not secured nor guaranteed according to the profit and loss sharing rules (Ahmed, 2005).

9.3.2.1.2 Activity Risks

These may differ according to the kind of project - agricultural or industrial production or commercial services etc. - which differ in the conditions affecting

them. For example, agricultural activities are affected by weather conditions, natural disasters and the availability of natural rural sources of production. On the other hand, industrial activities may be affected by and be dependent upon the availability of skilled labour as well as on the availability of (imported) raw material. Both of these require hard currency, a lack of which impacts on productivity as well as the prices of their products. Commercial activities are affected by the competition as a result of the entry of competitors and by storage and distribution – problems that the Sudan particularly suffers from (Ahmed, 2005).

9.3.2.1.3 General Circumstantial Risks

General circumstantial risks may be divided into economic and political and legal risks.

- (i) Economic situations change regarding things like goods that are sold and bought quickly and those that remain hard to sell. Such changes have nothing to do with the relationship between the banks and the entrepreneurs. Competition, in the broad meaning of the word, is a part of these risks. It can arise from the introduction of new substitutes in the market and the introduction of new technology by the producers, from changes in customers' preference (market trends). Other risk areas include money invested being riskier than that which is owned and invested by the owner, the rise in prices for international money transfers, the weakness of the construction and the lack of energy and the transfer to a type of consumerism (Ahmed, 2003).
- (ii) The political and legal risks: In any country these two factors affect the situation at differing levels. Without doubt, political stability greatly reduces these risks. Also fiscal and monetary pricing policies have very obvious effects. The laws that enable control of imports and exports affect the performance of government in various realms. The national economic strategy and regulations and policies on investment

laid down by the National Bank of Sudan (Sudan Central Bank) restrict and will affect banking operations too (Ahmed, 2003).

9.3.2.1.4 Operational Risks

Operational risks involve bad management, which lead to problems for the projects being financed. Losses are usually incurred as a result of poor investment decisions, which may derive from a mix of factors, including a volatile operating environment, weak internal governance (notably mismanagement), and limited market discipline. Such losses are reflected not only in depreciation of the value of the depositors' wealth, but also in a decline in banks profitability. If not corrected in good time, such decline can jeopardize the bank's soundness. This, in turn, can progressively reduce the banks' role as financial intermediaries and inhibit the mobilization of private savings towards investment (Errico and Farahbaksh, 1998).

9.3.2.1.5 Financial Risks

The change in the financial position of the company or the corporation and its failure to pay will affect a kind of risk (Ahmed, 2005).

9.3.2.2 Musharakah Risk Performance

This section aims to investigate the perception of the *musharakah* projects risks. Hence, it aims to respond to the following research question:

Research Question (8) What is the perceived financial performance of musharakah in terms of risk?

It is notable from table 9.5 that the P-value (significance or Asymp. Sig.) is equal to 0.0 for *musharakah* risk. The non-parametric test, therefore, confirms that the performance is not on the same level on all options according to the respondents views. Almost one third (30%) of the sample respondents believe that the *musharakah* risk is high with an additional 28% believing it is very high. In

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regards to those who consider *musharakah* risk to be acceptable or low they were simply 24% and 14% respectively.

Table 9.5 Musharakah Risk

	Valid	Frequency	Percent
Musharakah Risk Chi-Square 67.240 Asymp. Sig. .000	Very High	72	28.8
	High	75	30.0
	Acceptable	61	24.4
	Low or none	36	14.4
	Not sure	6	2.4
	Total	250	100.0

Concerning the risk there are three points that can be considered:

- (i) The moral commitment by the banks to facilitate and to finance small producers and poor families.
- (ii) The regulations for *musharakah* in Sudan do not allow any of the partners to takeout any kind of guarantee against the other partner. The only situation that allows a form of guarantee to be taken is that in respect of mismanagement and fraud. This leads to the bank not asking for sufficient guarantees and ignoring the credit-worthiness of the customer. As an alternative they ask for personal guarantors. These guarantees have never been used.
- (iii) The partnerships do not have a great deal of control over some operations, such as animal export, which may lead to the delegating of responsibility by the bank to the other partner and allowing the other partner to do whatever he or she wishes to do.
- (iv) Diversification strategy is advised to minimise the risks through financing different entrepreneurs instead of concentration of finance to a few of them, diversification in financing different sectors in different seasons

- (v) This specialization is also advised. It probably will have some far reaching consequences. In the first instance, the bank may accumulate intimate knowledge of some markets in which they have concentrated. This may enable the banks to protect themselves more efficiently against too optimistic entrepreneurial calculations in these areas, although a perfect protection seems to be impossible (Al-Harran, 1997).
- (vi) In high risk projects, the researcher recommends selecting carefully good entrepreneurs and hence minimising possible defaults; older entrepreneurs with good track records can take part in nominating new entrepreneurs.
- (vii) Improving the contract conditions which can minimize risk and give more authority to following up these projects.
- (viii) Part of the profits could be used to build up reserves as a buffer against possible future losses (Karsten, 1982).

9.3.2.3 The High Risk of *Musharakah* Contracts Causes Great Institutional Influence on Management Decisions

This section intends to examine the influence of *musharakah* risk on management decisions. Therefore, it aims to respond to the following research question:

Research Question (9) What is the perceived impact of musharakah risk on the degree of interference on management?

Consideration of the entrepreneur's wishes of no interference is essential, even though it may at times cause weak monitoring. By contrast the high risk of *musharakah* contracts causes great institutional influence on management decisions. So a sense of balance is, indeed, needed in these cases. As shown in table 9.6, the majority of respondents, with significant chi-square level, agreed that it may cause an influence on management decisions: 30% and 36% of them agreed and strongly agreed with this respectively. By contrast, 22% disagreed and only less than 3% of them strongly disagreed with this assertion. In addition,

only 8% of the respondents were uncertain. These differences are statistically significant, as the chi-square value is below 0.05.

Table 9.6 The Influence of *Musharakah* Risk on Management Decisions

		Frequency	Percent
The high risk of <i>musharakah</i> contracts causes great institutional influence on management decisions Chi-Square 106.240 Asymp. Sig. .000	Strongly Agree	76	30.4
	Agree	92	36.8
	Uncertain	20	8.0
	Disagree	56	22.4
	Strongly Disagree	6	2.4
	Total	250	100.0

It is most important to recognize the impact of PLS modes of financing on Islamic banks, especially the fact that when Islamic banks provide funds through their PLS facilities, there is a recognizable default on the part of the agent-entrepreneur until PLS contracts expire, barring proved negligence or mismanagement on the part of the agent-entrepreneur. In fact, a default of PLS contracts means that the investment project has failed to deliver what was expected, that is a lower or no profit, or loss. In this case, the lower profit or loss is shared between or among parties according to the stipulated PLS ratios (Errico and Farahbaksh, 1998).

Islamic banks, therefore, have a lower degree of control over the management of the enterprise they finance through the PLS contract. By contrast, credit risk related to financing through non-PLS modes are lessened by the possibility of collateralization, including mortgaging. The assessment of an appropriate level of the capital adequacy ratio for Islamic banks should be primarily based on systematic analysis of the underlining asset portfolio between PLS and non-PLS transactions (Errico and Farahbaksh, 1998). Although the PLS contracts perhaps present significant risks to Islamic banks, it also presents a profitable opportunity. Accordingly, the assessment and management of investment risk

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becomes more difficult in an Islamic environment than in conventional banking because of the following factors:

- (i) PLS modes cannot be systematically made dependant on collateral or other guarantees;
- (ii) Administration of the PLS modes is more complex compared to conventional financing;
- (iii) The relatively weak legal framework supporting bank lending operations.

Another point to be added here is that the dual Islamic and conventional banking system taking place in Sudan since 2006 may increase the level of competition between Islamic banks from one hand and Islamic and conventional banks from the other hand. This greater competition, though driving firms to improve their efficiency, may also encourage them to orient their businesses towards activities, sectors, and/or entrepreneurs of higher risk. In order to safeguard invested funds and realise profits, Islamic banks will need to rely more than conventional banks on a set of appropriate policies and adequate infrastructure for portfolio diversification, monitoring and control. They would also need to rely on the existence of an adequate supply of trained banking staff skilled in investment and Islamic banking practices to implement these policies.

To conclude, there is a need for risk analysis and risk management tools to provide agents with hedging instruments, especially with Islamic banks. In conventional banks, interest rates play a key role in managing liquidity, pricing risk and allocating credit. In the absence of the interest rates, the risk manager in an Islamic bank faces a greater challenge than the risk manager of a similar size conventional bank. In addition, Islamic banks are unlikely to benefit from a critical mass of similar institutions with which the Islamic bank can be developed, thus requiring Islamic banks to hold higher levels of liquidity than conventional banks, with a consequent negative impact on their ability to compete.

9.3.3 Risk and Profitability Analysis

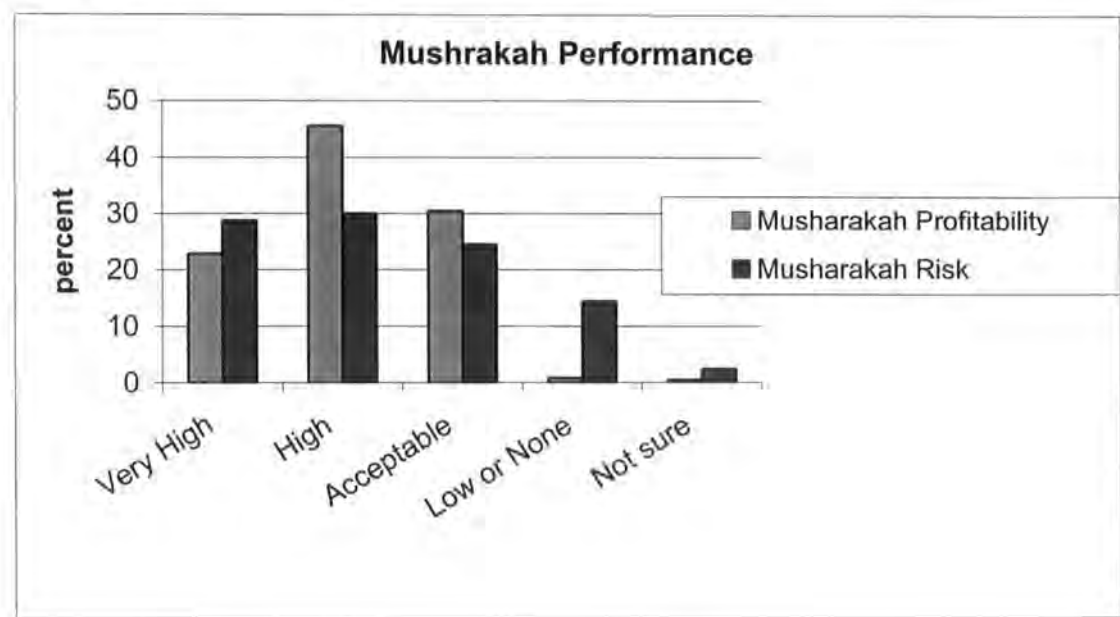
In the case of *musharakah*, Islamic banks have to carry out feasibility studies with more depth and precaution (Usmani, 1999). Since these projects will be carried out by feasibility studies, then risk management can be developed to minimise the exposed risks and to maximise the expected profitability. Therefore, more likely, these banks will be able, in time through accumulated experiences, to develop their own approaches to accept only those projects which fulfil the need of achieving higher profitability. In addition, risk management tools will always contain a diversified portfolio of *musharakah* projects as no bank can restrict itself to a single *musharakah*, therefore, it is hardly conceivable that all of these *musharakahs*, or the majority of them will result in a loss. Provided that, some loss occurred can be attributed to chance or luck, for the rest, some of them will only make a loss if proper measures have been taken while high returns are expected for exposing more risks compared with semi profitability guaranteed projects. Hence, if well managed, the possibility of loss for the bank is much less theoretical, or at worst, equal, than the possibility of loss in a joint stock company which will be restricted to a limited sector of commercial activities.

In regard to the performance of the risk compared with the profitability, it is generally clear, from figure 9.3 that there is a harmony between the risk and profitability of *musharakah*: whenever one increases, the other also increases and vice versa. This financial activity is consistent with the economics principle which states that there should be proportionality between profit and risk. Hence, the researcher might say that the profitability is quite high and the risk is to some extent also high. However, *musharakah* profitability is higher than its risk.

Ahmed (2005) studied the *musharakah* profitability and risks compared with *murabahah*, *salam* and other Islamic finance instruments in Sudan. His results show that the *musharakah* method in two out of nine Sudanese banks had higher profitability and lower risk compared to other methods. Likewise, *murabahah* was better in another two banks only because it had a higher profitability

significant. His analysis has shown no differences between the methods for the remaining five banks. Ahmed (2005) reported that lack of knowledgeable bankers in selecting, evaluating and managing profitable projects is a significant factor.

Figure 9.3 Risks and Profitability for *Musharakah* (Respondents' Perception)



Are there any differences in the degree of profitability and risk between the different managerial experience groups of the respondents and different groups of the respondents who worked for the various sampled banks? The ANOVA test was used to answer this, the results of which are presented in table 9.7

The results show that there is no significant difference in any of the different managerial groups in their assessment of both the profitability and risk of *musharakah*, since their significances are bigger than 0.000. On the other hand, there are significant differences between the respondent groups in terms of their assessment to the degree of risk that *musharakah* contains with a significance value of 0.018.

Table 9.7 Analysis of Variance ANOVA for *Musharakah* Performance According to Managerial Experience and Sampled Banks Groups

			Mean Square	F	Sig.
Managerial performance	Profitability	Between Groups	.474	.800	.527
		Within Groups	.593		
	Risk	Between Groups	2.106	1.733	.143
		Within Groups	1.215		
Banks	Profitability	Between Groups	1.047	1.810	.086
		Within Groups	.578		
	Risk	Between Groups	2.925	2.478	.018
		Within Groups	1.180		

Hence, the respondents, regardless of their managerial experience and the bank they work for, have assessed the *musharakah* profitability without difference, while the results show the differences between the respondent groups according to their banks in their assessment to *musharakah* risk. Table 9.8 elaborates these differences.

Table 9.8 ANOVA Multiple Perception Comparisons between Sampled Banks on Dependent Variable: Performance of *Musharakah* Risk

(I) Name of the Bank	(J) Name of the Bank	Mean Difference (I-J)	Sig.
Shamal Islamic Bank	Savings Bank	.02564	.917
	Sudanese Islamic Bank	.18168	.473
	Tadamoun Islamic Bank	-.24599	.343
	Faisal Islamic bank	.41026	.118
	Bank of Khartoum	-.34836	.192
	Omederman National Bank	.36859	.192
	Saudi Sudanese Bank	.60073(*)	.042
Savings Bank	Shamal Islamic Bank	-.02564	.917
	Sudanese Islamic Bank	.15604	.538
	Tadamoun Islamic Bank	-.27163	.296
	Faisal Islamic bank	.38462	.142
	Bank of Khartoum	-.37401	.162
	Omederman National Bank	.34295	.225
	Saudi Sudanese Bank	.57509	.052
Sudanese Islamic Bank	Shamal Islamic Bank	-.18168	.473
	Savings Bank	-.15604	.538
	Tadamoun Islamic Bank	-.42768	.109
	Faisal Islamic bank	.22857	.394
	Bank of Khartoum	-.53005	.053
	Omederman National Bank	.18690	.517
	Saudi Sudanese Bank	.41905	.164
Tadamoun Islamic Bank	Shamal Islamic Bank	.24599	.343
	Savings Bank	.27163	.296
	Sudanese Islamic Bank	.42768	.109
	Faisal Islamic bank	.65625(*)	.017
	Bank of Khartoum	-.10237	.714
	Omederman National Bank	.61458(*)	.037
	Saudi Sudanese Bank	.84673(*)	.006
Faisal Islamic bank	Shamal Islamic Bank	-.41026	.118
	Savings Bank	-.38462	.142
	Sudanese Islamic Bank	-.22857	.394
	Tadamoun Islamic Bank	-.65625(*)	.017
	Bank of Khartoum	-.75862(*)	.007
	Omederman National Bank	-.04167	.888
	Saudi Sudanese Bank	.19048	.536
Bank of Khartoum	Shamal Islamic Bank	.34836	.192
	Savings Bank	.37401	.162
	Sudanese Islamic Bank	.53005	.053
	Tadamoun Islamic Bank	.10237	.714
	Faisal Islamic bank	.75862(*)	.007
	Omederman National Bank	.71695(*)	.018
	Saudi Sudanese Bank	.94910(*)	.003

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(I) Name of the Bank	(J) Name of the Bank	Mean Difference (I-J)	Sig.
Omederman National Bank	Shamal Islamic Bank	-.36859	.192
	Savings Bank	-.34295	.225
	Sudanese Islamic Bank	-.18690	.517
	Tadamoun Islamic Bank	-.61458(*)	.037
	Faisal Islamic bank	.04167	.888
	Bank of Khartoum	-.71695(*)	.018
	Saudi Sudanese Bank	.23214	.475
Saudi Sudanese Bank	Shamal Islamic Bank	-.60073(*)	.042
	Savings Bank	-.57509	.052
	Sudanese Islamic Bank	-.41905	.164
	Tadamoun Islamic Bank	-.84673(*)	.006
	Faisal Islamic bank	-.19048	.536
	Bank of Khartoum	-.94910(*)	.003
	Omederman National Bank	-.23214	.475

As indicated by the mean differences in the table 9.8, respondents who work for Saudi Sudanese Bank consider their *musharakah* risks higher when compared with respondents working for *Shamal* Islamic Bank, *Tadamoun* Islamic Bank and Khartoum Bank. Respondents who work for *Faisal* Islamic Bank consider their *musharakah* risks higher when compared with respondents working for *Tadamoun* Islamic Bank and Khartoum Bank. Staffs of *Omderman* National consider *musharakah* financed by their bank to have a higher risk compared with a degree signed by the respondents working for *Tadamoun* Islamic Bank and Khartoum Bank. Lastly, *Tadamoun* Islamic Bank respondents consider their *musharakah* risk higher compared to their counterpart in Khartoum Bank. The rest of the banks consider their risks on the same level. Hence, the respondents of Khartoum Bank consider their *musharakah* risk as the lowest among all sampled banks.

9.3.4 Profitability and Risk Financial Performance of Islamic Financial Methods: Method's Return of Equity and Debt Equity Ratios

Until here, perception analysis of the participants is presented. Against this perception analysis, this section aims to take the research further to investigate the real financial performance of *musharakah* compared with *murabahah*, *salam*

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and other methods of Islamic finance in the case of Sudan by utilising secondary data as opposed to the primary data utilised so far. It is crucial to mention that since the data collection process is terribly difficult in Sudan, consistent data were only available for the period of 1993-1999. It was not possible to gain access to the data for the period 2000 – 2005 due to three reasons:

- (i) Current information on the banks' bad debts as reported to central banks regarding classified methods is not easily accessible to researchers;
- (ii) Some banks' information systems do not provide information per method of finance. Data per method of finance should be collected per branch first then accumulated. This took substantial time to work out for the existing available data for the period 1993-1999;
- (iii) Some banks were reluctant to provide recent data about their performance, so they only allowed old data.

This section, thus, compares the performances or the profitability and risks of various Islamic financial instruments by using secondary data for the period of 1993-1999. Before presenting the results of ANOVA test investigating the significance of the performance differences, it is important to state that a number of calculations were initially conducted to prepare the ground for performance differential analysis. For the purpose of this section of the study the profitability and risk will be judged by the following criteria:

Risks measured by the method debt equity ratio (MDER) =method's debt/ capital equity.

Profitability measured by the method profit ratio (MFR) =method's profit /total capital equity.

If the researcher wishes to consider banks' efficiency controlling by risk, only those loan losses arising from internal factors, such as risk management inefficiency or bad management, should be considered, while risk generated by adverse local business conditions (bad luck) should be excluded. Based on this,

table 9.9 presents the results of the ANOVA test for the differences between the financial performance of *musharakah*, *murabahah*, *salam* and other methods in terms of profitability and risk.

Table 9.9 Risk and Profitability for the Islamic Finance Methods

		Mean Square	F	Sig.
Profitability	Between Groups	.010	1.059	.385
	Within Groups	.009		
Risk	Between Groups	.040	.724	.547
	Within Groups	.055		

As shown in table 9.9 the profitability analysis shows there is no difference between the methods as their significance is 0.385, which is bigger than 0.05. Similarly the risk analysis shows that there is no significant difference between these methods in terms of risk rates, stating, as the F test shows the significance to be 0.547. The researcher can, therefore, conclude that there is no difference between the profitability and risk of these methods, namely *musharakah*, *murabahah*, *salam*, and other methods².

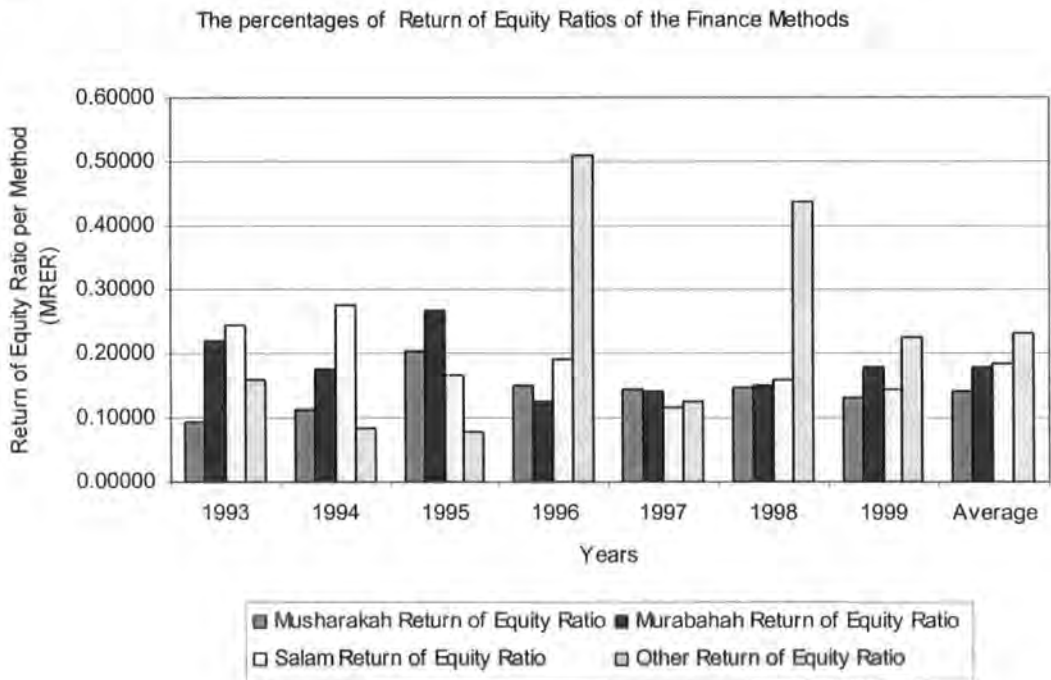
A common principle of economics is that of scales moving in the same direction when discussing profitability and risk. When there is high risk one should expect high profits and when there is low risk one should expect low profits. The analysis in this section was expecting to have some methods with both high profitability and high risk but this didn't happen. However, these results describe the rational movement for the fund between the methods; whenever a method gives more probability for profit in some incidents there will be a preferred

² On an individual banking level, the researcher has studied the performance of the sampled bank. The statistical analysis has shown that the *musharakah* method in two individual banks had higher profitability and lower risk compared to other methods. Likewise, *murabahah* was better in another two banks only because it had a higher profitability significant. The analysis has shown no differences between the methods for the remaining five banks. This indicates that lack of knowledgeable bankers in selecting, evaluating and managing profitable projects is a significant factor. This paper closely studies the results for the four banks for which there were significant differences, to measure the efficiency of the Islamic finance methods and the lack of PLS performance. For full discussion of the study see Ahmed, G. A. (2005). "Risk and Profitability for the Islamic Finance Methods." Review of Islamic Economics Vol. 9(No. 2): 31 - 75.

economic choice and the opposite is true; whenever a method gives less probability for profit in some incidents the preferred economic choice will be converted to a new preferred method. *Ceteris paribus*, such statements can be used to describe the risk.

Figure 9.4 depicts the profitability of the methods. As can be seen, it shows that *musharakah* had the lowest average profitability during the time when the other methods had the highest profitability. Figure 9.4 further shows that the averages of their profitability are 14%, 18%, 18.5% and 23% for *musharakah*, *murabahah*, *salam* and other methods respectively. The reason why *murabahah* is greater than *musharakah* may be because its profits are more guaranteed compared with *musharakah*. As mentioned before, *murabahah* is the selling of collateral by covering the cost price with a fixed and known profit margin. The bank usually takes some guarantees from the customers and these guarantees can be cheques. The consequences for giving RD/bounced cheques to banks as stated by the Sudanese criminal law in 1991 is imprisonment until the cheque is fully paid (Article No 179, 1991 Sudanese Criminal Act).

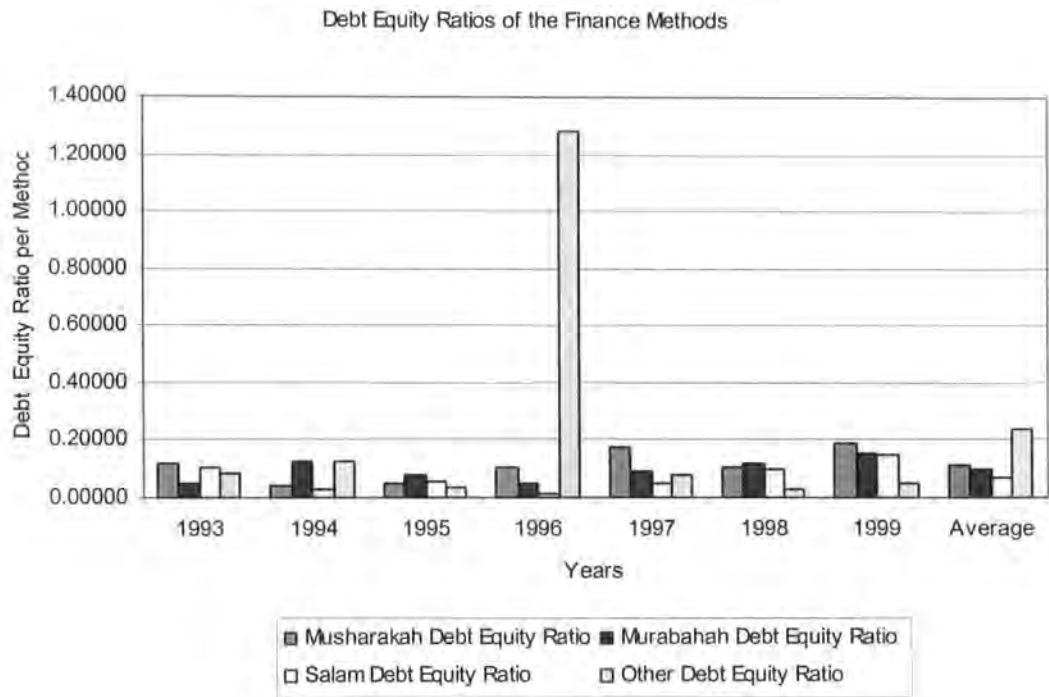
Figure 9.4 Profitability Performance for Islamic Finance Methods



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It is for that reason that many customers were put in prison. This is seen as a pressure on *murabahah*. Because of the problems associated with it, the BOS placed profit ceilings upon *murabahah* projects that banks are forbidden to go over (Bank of Sudan 1990-2006). For the same reason they are also planning to set a limit on the amount of funds that can be given over to *murabahah* use. The other methods are also justified by the results, as are all different ways that increase profitability and reduce risk. The researcher cannot find a justification for the high profitability of *salam* when compared with *musharakah*. This is not because of an agricultural disaster – something that did not occur in Sudan in this period – but because the agricultural season does not usually begin on time and there is not enough investment, as well as the fact that, as banks often complain, the *salam* given to farmers is not being used for crop growing. The *salam* and their non-payment were the reasons for the prosecution of some of the farmers. It was expected therefore that the profitability of the *musharakah* will be at least slightly higher. Figure 9.6 describes the risk rates for the Islamic financing methods in relation to arrears and bad debts, which depicts that the other methods had the highest risks. This is in line with the principle that there is a proportional relationship between profit and risk.

Figure 9.5 Risk Performance for Islamic Finance Methods



The average of the debt equity ratios for the other methods is 22%. Nevertheless this was because of the extraordinary and odd result in the year 1996. At the time, *salam* was the lowest risk with an average of 7% while *musharakah* and *murabahah* achieved 11% and 9.5%.

One way to solve the moral hazard problem with *musharakah* is to increase project monitoring and enforce restrictive covenants. Sudanese banks have paid little attention to developing their project appraisal capabilities. The moral hazard problem makes it desirable for the banks to monitor the performance of the projects they finance. No doubt, this entails additional costs but the benefits in terms of final declared profits more than offset those. In spite of this, the banks have been reluctant to do that because the entrepreneurs tend to resist it. They have instead chosen the easier way out, i.e. fixed return modes.

Debts rate is usually an indication of the managerial efficiency especially of those projects which depend on following up, management and control, notably

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musharakah projects. Management is defined as initiation of projects (demand and feasibility studies, project proposals etc.) and implementation of these proposals by active involvement in the production process. Control on the other hand is defined as the right to ratify the initial proposals and supervise the projects either through internal monitoring or external mechanisms (Dar and Presley 2000). Accordingly, strengthening the managerial efficiency of these banks is strongly advised.

The proportional relationships between profit and risk for these methods, as shown in figure 9.6, 9.7, 9.8, and 9.9, with the exception of *musharakah* was stable, with constant profit returns being higher than the risk. This indicates the managerial efficiency in following up these projects, as *musharakah* requires two main actions: exceptional feasibility studies and constant re-appraisal. It appears therefore, from what has been mentioned previously, that the level of re-appraisal is low. The same happened to *salam* and the other methods. By contrast *murabahah* did see a proportional relationship between risk and profit, especially over the last four years of the period of study.

Figure 9.6 Musharakah Profitability and Risk

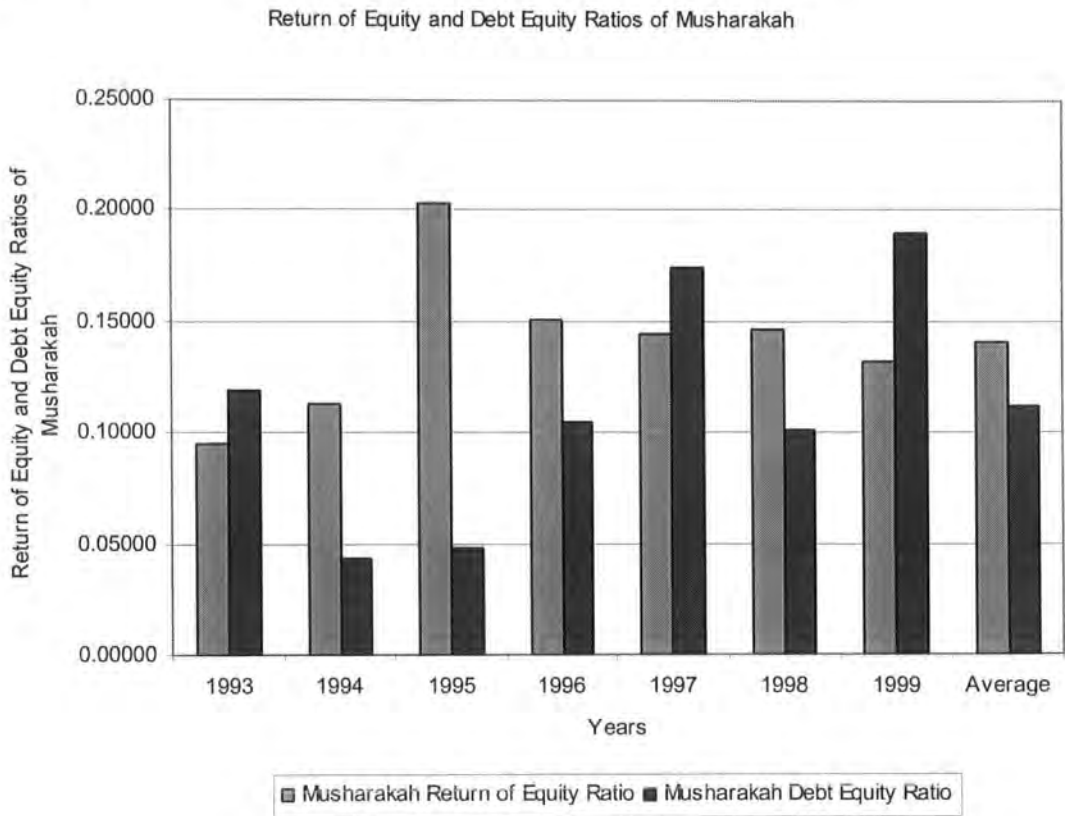


Figure 9.7 Murabahah Profitability and Risk

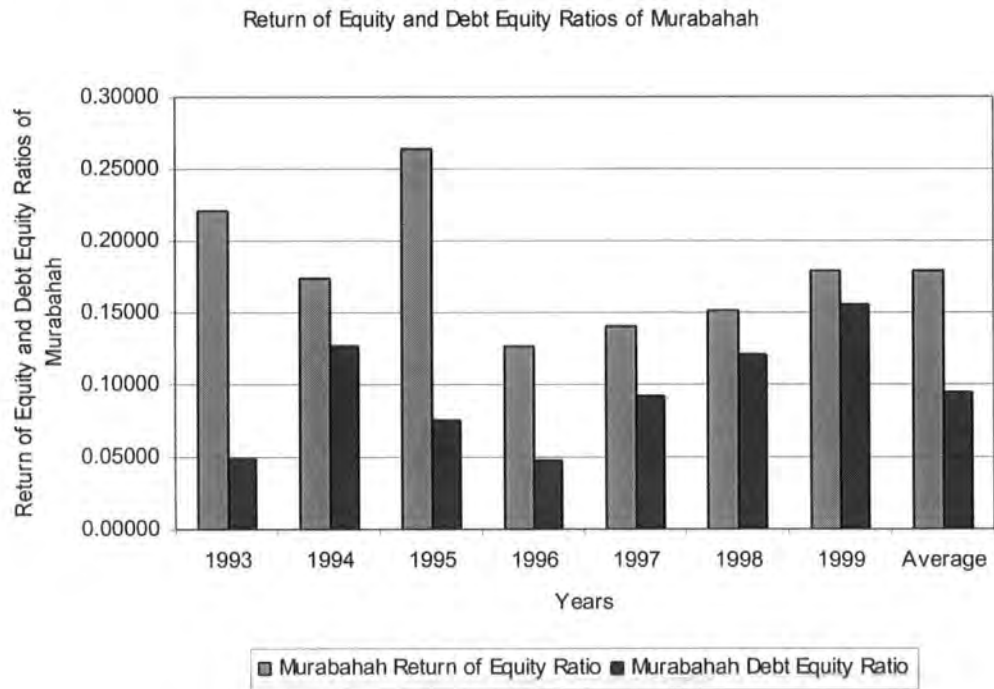


Figure 9.8 Salam Profitability and Risk

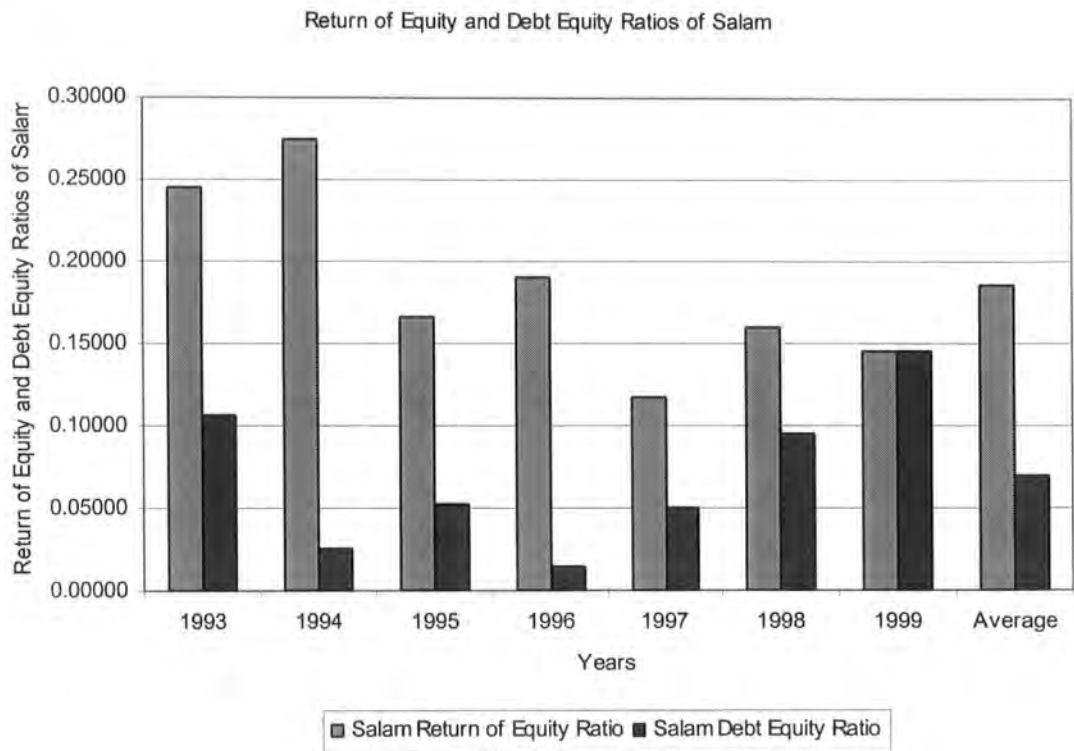
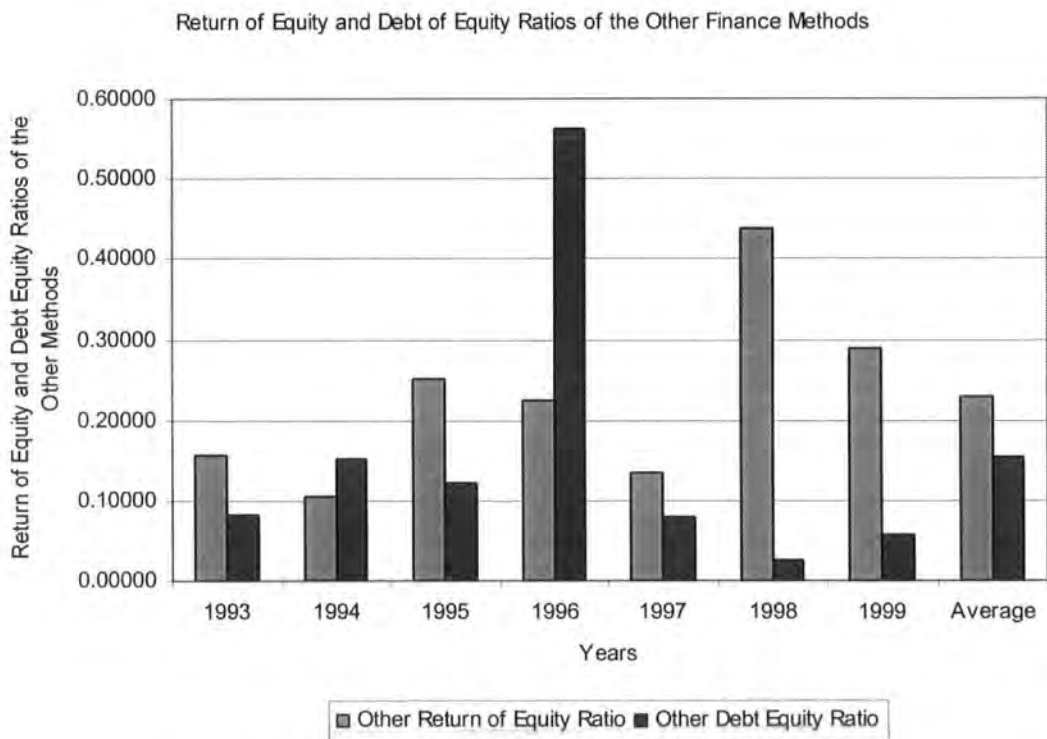


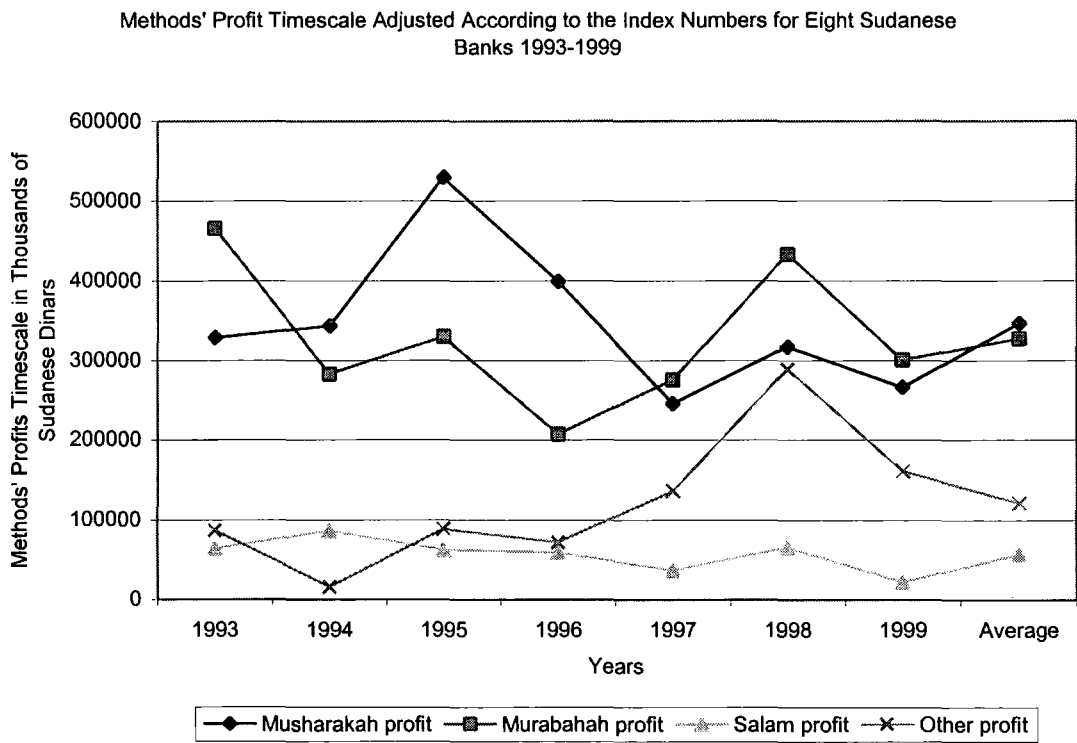
Figure 9.9 Other Finance Methods' Profitability and Risk



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After dividing the numbers into the currency index as in Figure 9.10, this study found that the average profitability of the *musharakah* were the highest followed by *murabahah*, which is consistent with the results mentioned before, but more accurate. Moreover *musharakah* was the highest performing in 1995-1997. *Murabahah*, on the other hand, had fluctuating profits, while *salam* had a constant but low average profitability level. The year 1996 saw the least profit for the *salam* method due to that year's agricultural season. With regard to the other methods, they saw a gradual increase in their average profitability between 1993 and 1998. The average profit margin did decrease however in 1999.

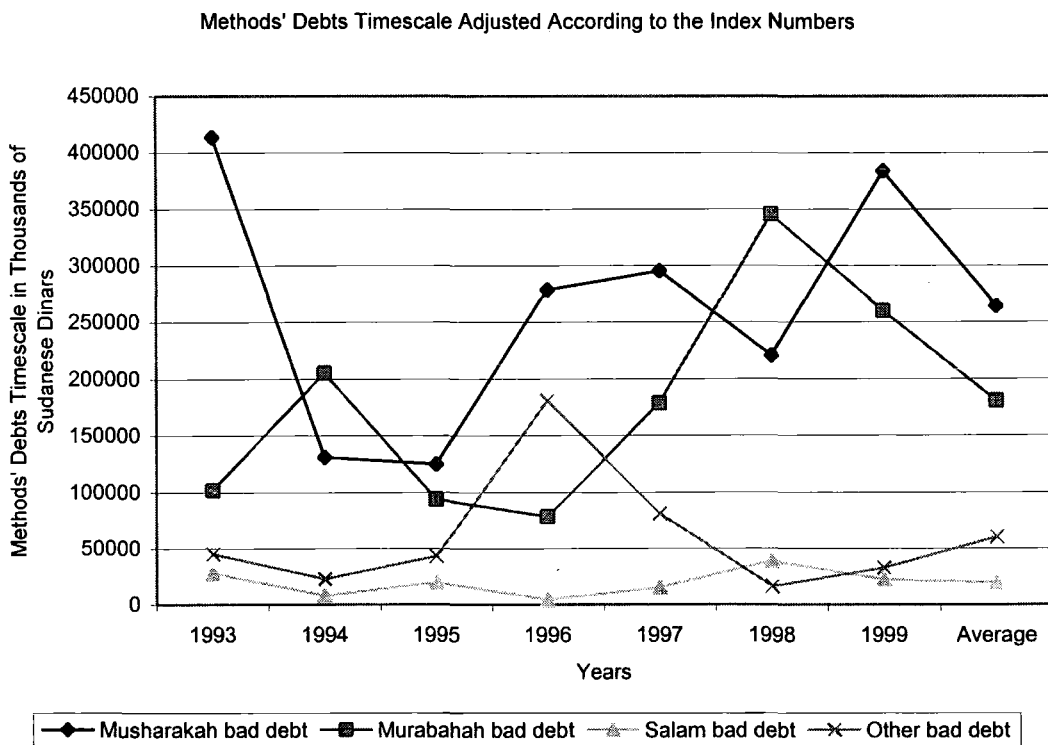
Figure 9.10 Profitability of the Islamic Finance Methods Adjusted by the Index Numbers



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The timescale for these methods, when comparing their performance in covering their bad debts over time as is depicted in figure 9.11, shows high fluctuations, which do not conform to the profitability over time. It should also be stated that *salam* was the lowest bad debt method and again it had a constant but low average bad debts level.

Figure 9.11 Risk for the Islamic Finance Methods Adjusted by the Index Numbers



9.4 Pecking Order for Islamic Finance Instruments

9.4.1 Preference of Islamic Financial Methods

This section intends to investigate the preference for Islamic finance instruments. Hence, it aims to respond to the following research question:

Research Question (10) What is the most preferred instrument among Islamic finance methods according to the respondents' perception?

The result of the chi-square goodness-of-fit test indicates, as shown in table 9.10, that there is reasonable very low likelihood that the differences in the Islamic finance methods preference in the sample data can be attributed to chance. In spite of the high risk of *musharakah* mode of finance and the high management skills needed, most of the respondents prefer *musharakah* as their mode of finance in dealing with their customers. As shown in table 9.10 almost 60% of the respondents preferred *musharakah* and by contrast only about 35% of them selected *murabahah*, whilst less than 3% chose the *salam* mode of finance and less than 3% of the respondents selected other modes of finance including *mudarabah*, *istisnaa'*, *muzarahah* and *mosagah*. This may show the support of the banks' employees to *musharakah*.

Hence, the most preferred finance instrument is *musharakah* followed by *murabahah*.

Table 9.10 Preference of Islamic Finance Instruments

		Frequency	Percent
Preference of Islamic financial methods Chi-Square 225.936 Asymp. Sig. .000	<i>musharakah</i>	148	59.2
	<i>murabahah</i>	88	35.2
	<i>salam</i>	7	2.8
	Other	7	2.8
	Total	250	100.0

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The managers as well as customers are guided by a pecking order when choosing among financing opportunities. The most popular reason for this behaviour, as mentioned by Read (1998), is due to control, which is the desire to avoid external interference and maintain independence. The amount of debt or equity sought is determined, to a large extent, by the enterprises owner's and managers' goals of protecting the control of enterprise. Nasr (2005) argues that if the pecking order hypothesis holds, then, owners should be reluctant to use the *musharakah* mode of finance mainly due to the absence of a control factor from the demand side and high risk embedded in the instrument from the supply side. According to Nasr (2005) small business owners prefer to be financed using *murabahah* then *ijarah wa iqtinaa*, followed by *mudarabah* and lastly *musharakah*. The results shown above, by contrast, do not support his outcomes. The reason the researcher can put forward is that, as Nasr (2005) mentioned, there were several factors that potentially restrict his conclusions to be drawn from his study. This is due to the small number of distributed and collected survey (45 respondents from which only a few have been financed using *musharakah*) and the low education level of the respondents. In addition the sample contains a high percentage of Christians.³ In Sudan, some clients who reject interest-based loans may be sceptical about *murabahah*, with its strict collateral requirements which bear an apparent similarity to interest-yielding loans. Such clients may welcome *musharakah*, which minimizes the pressure exerted on clients by the financier (Abdalla, 1997). However, in big businesses, especially lucrative ones, some clients would prefer *murabahah* because they would know in advance the exact amount they will pay as a profit margin and at the same time keep banks away from direct intervention in their businesses. On the other hand, banks would prefer *musharakah* since the end return on investment would be higher. In non-lucrative businesses this scenario is reversed. Banks would go for *murabahah*, especially when dealing with risky small businesses (Abdalla, 1999).

This is a distinct feature of the SIBs experience. The entrepreneur in *musharakah* financing is entitled to a share in the business profit pro rata to his contribution in

³ The study has been conducted on the customer demand side on *musharakah* in the urban area of Cairo.

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the investment (in addition to earnings gained as management entrepreneurship fees). Thus, he would be tempted, in order to increase his profit share, to save or reinvest his profits in buying out the bank shares. This is another important advantage of *musharakah* i.e., encouragement or mobilisation of savings.

It should be noted that these stated preferences, however, are not necessarily reflected in real life. To some extent these preferences may be the result of an awareness of Islamic Finance.

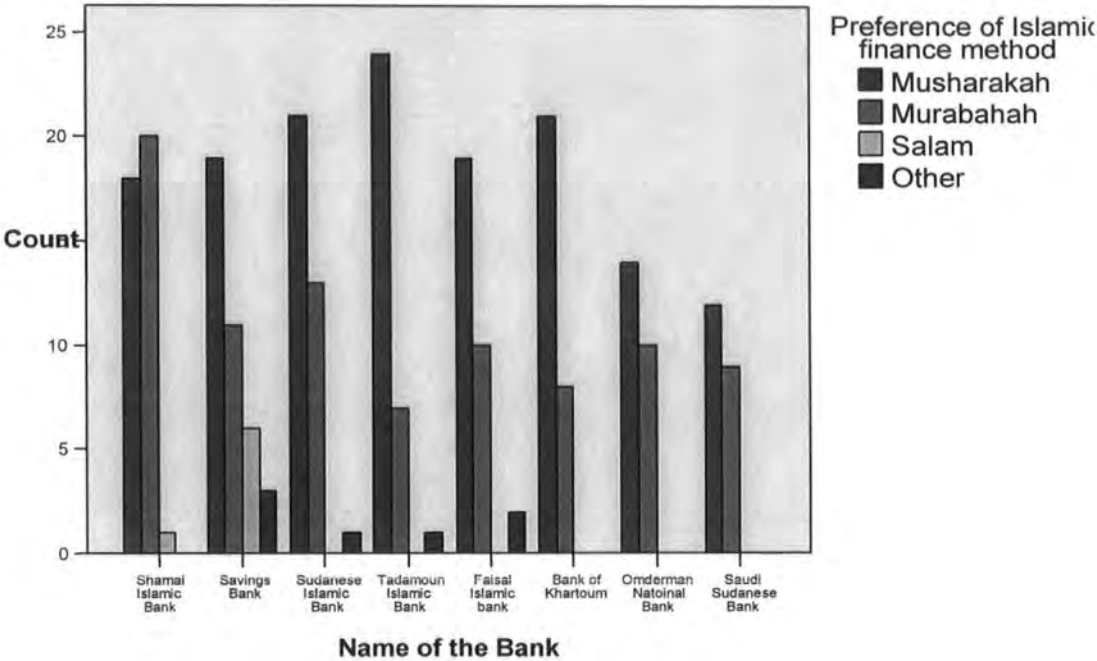
Table 9.11 presents the results of cross tabulation between the preferred mode of finance and the sampled banks, which shows that there is a relation between the bank and the mode of finance preferred since its Chi-Square significance is equal to 0.002.

Table 9.11 Cross Tabulation and Chi-Square Tests for the Different Sampled Banks and the Preferred Method of Finance

		Value	df	Asymp. Sig. (2- sided)
Name of the Bank * preference of the Islamic finance method	Pearson Chi-Square	45.212(a)	21	.002
	Likelihood Ratio	40.188	21	.007
	Linear-by-Linear Association	5.197	1	.023
	N of Valid Cases	250		

To illustrate this, figure 9.12 shows the distributions of preference percentages among different sampled banks. The figure shows that *murabahah* is preferred in *Shamal* Islamic bank, while the rest of the seven banks prefer *musharakah*. *Salam* finance is weak in all banks except in Savings Bank.

Figure 9.12 Preferred Mode of Finance in the Sampled Banks



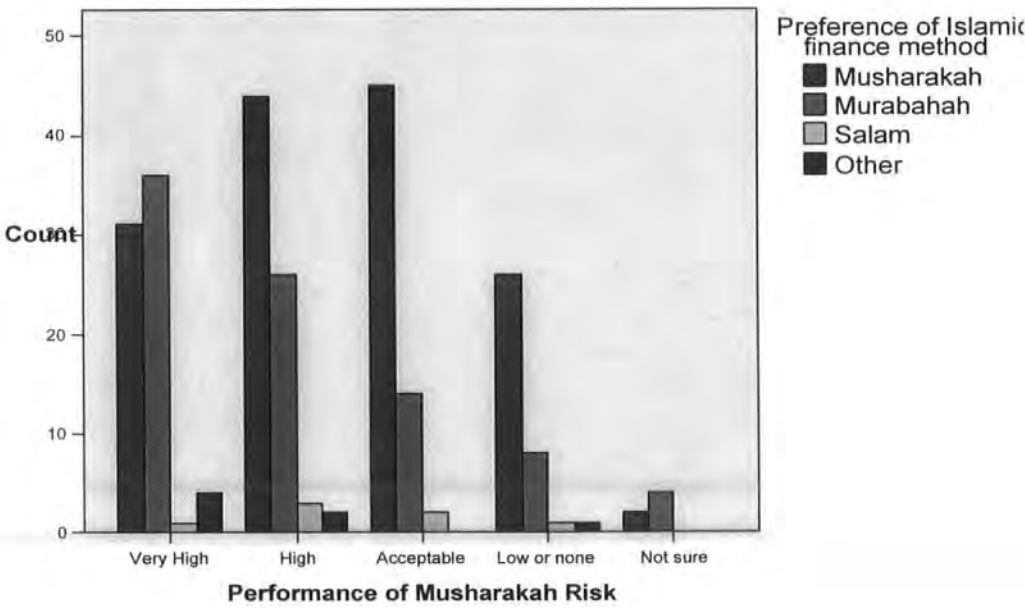
In order to see whether there is a relation between the mode of finance preferred and the degree of profitability and risk signed for these modes by the respondents the chi square cross tabulation test was run. The results are demonstrated in table 9.12. The results show that the degree of profitability and risk correlate with the mode of finance preferred with significant difference.

Table 9.12 The Relation between the Preferred Mode of Finance and Musharakah Performance

		Value	df	Asymp. Sig. (2-sided)
Performance of Musharakah Profitability * Preference of Islamic finance method	Pearson Chi-Square	22.967(a)	12	.028
	Likelihood Ratio	12.001	12	.446
	Linear-by-Linear Association	1.792	1	.181
	N of Valid Cases	250		
Performance of Musharakah Risk * Preference of Islamic finance method	Pearson Chi-Square	22.516(a)	12	.032
	Likelihood Ratio	24.180	12	.019
	Linear-by-Linear Association	7.418	1	.006
	N of Valid Cases	250		

Figure 9.13 illustrates this relation. While most of those who preferred *murabahah* have ranked *musharakah* risk as very high and high, those who preferred *musharakah* consider its risk as acceptable. Hence, there is a strong relation between *musharakah* risk performance and the preferred mode of finance.

Figure 9.13 Musharakah Risks Performance and the Preferred Mode of Finance



9.4.2 Perception Related Factors Influencing Granting Credits and Hindering Musharakah Investment in Fund Allocations

This section aims to identify factors influencing granting credits and hindering *musharakah* investment in fund allocations. Therefore, it aims to respond to the following research question:

Research Question (11) What are the possible factors influencing granting credits musharakah finance according to the perception of the respondents?

Table 9.13 presents the relevant importance of some selected perceived factors influencing granting credit and hindering investment in fund allocations. These factors are risk, limited credit ceilings, profitability and personal qualities of the entrepreneurs. The descriptive analysis shows that the most influencing factor is the profitability with significant points of 1290 followed by risk factor on the second place and limited credit ceiling with 1219 and 1053 points respectively. It is important to mention that these differences and the mean rank difference shown in table 9.14 are not significant which show a significance of .145.

Table 9.13 Factors Hindering *Musharakah* Finance and Allocation Fund

Factors		Significance					Weighted significance points
		Ranked 1 st	Ranked 2 nd	Ranked 3 rd	Ranked 4 th	Total	
Profitability	F	54	62	85	49	250	1290
	P	21.6	24.8	34.0	19.6	100.0	
Risk	F	51	89	61	49	250	1219
	P	20.4	35.6	24.4	19.6	100.0	
Limited credit ceilings	F	61	54	47	88	250	1053
	P	24.4	21.6	18.8	35.2	100.0	
Personal qualities of the entrepreneurs	F	84	45	57	64	250	938
	P	33.6	18.0	22.8	25.6	100.0	

Table 9.14 Friedman Tests and Mean Ranks for the Factors Hindering Musharakah Finance

	Mean
Risk	2.4320
Limited credit ceilings	2.6480
Profitability	2.5160
Personal qualities of the clients	2.4040
Chi-Square Friedman Test 5.400 Df 3 Asymp. Sig. . 145	

Hence, to answer the research question, all the factors studied significantly have the same weight of importance.

9.4.3 Factors Affecting the Distribution of Bank Funds According to the Different Methods of Finance

This section aims to identify the factors affecting the distribution of bank funds according to the different methods of finance. Hence, it aims to respond to the following research question:

Research Question (12) What are the perceived possible factors influencing the distribution of bank funds among different Islamic finance instruments?

The choice of one mode of Islamic finance over another is influenced to a large extent by the suitability of the nature and type of business; the size of loan; and the base of lending (individual or group). Choosing between one mode of finance or another depends on a number of factors, including the character and trustworthiness of the entrepreneur; the capital amount needed; the conditions under which the business operates and the collateral required to ensure business success. In an attempt to decide factors affecting the distribution of bank funds according to the different methods of finance, the respondents were given six factors to rank according to their importance. These factors are credit policies set by the BOS, the amount of fund available, risk of finance methods, profitability

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of finance methods, the activity type, and other factors. The descriptive distributions are shown in table 9.15 and the results of Friedman Tests and the mean ranks are shown in table 9.16.

The results indicate that respondents placed greatest importance on credit policies set by the Central Bank and greater importance on the amount of funds available and risk of finance methods. Factors such as profitability of finance methods, the activity type and other factors score relatively less. The majority of respondents (75%) believe that the BOS credit policy is the first important factor and almost 10% of them believe it is the second important factor. On the other hand the table shows that the amount of funds available is the second important factor giving that almost 37% of the respondents believe so while the percentages of them who chose it as the third, fourth or fifth important factor was less than 20% for each rank. In addition to that the respondents believe that the risk of finance method is the third important factor affecting the decision of distributing funds available to different methods of finance to their budgets. Almost one third of the respondents consider risk factor as the third important factor, whilst 27% of them believe it is the fourth important factor. The respondents also believe that the profitability of finance methods is the fourth important factor with 32%. Then the activity type comes in as the fifth important factor with 42%. Lastly other factors rank as the sixth and the least important factor.

Table 9.15 presents weighting of the results. The weighted significance points column based on six points for the most important factor, five points for the second most important, and so on. The total scores column has been calculated by adding and submitting all scores given by respondents. The results of the weighting significance points go in the same direction; credit policies set by the Central Bank came first with 956 points followed by amount of funds available then the risk of methods in second and third position with 686 and 638 points respectively.

To take the research further, the Friedman test was run to identify whether these differences are attributed to chance. The result of the Friedman test chi-square

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test shown in table 9.16 indicates that there is reasonable very low likelihood that the differences between the mean ranks in the sample data can be attributed to chance. The mean rank confirms the results derived from weighted significance points, which also confirm the same ranking mentioned in the descriptive analysis above.

Table 9.15 Factors Influencing Distribution of Funds among Different Financing Instruments

Rankings		Significance							Weighted significance points
		R 1 st	R 2 nd	R 3 rd	R 4 th	R 5 th	R 6 th	Total ⁴	
Factors									
Credit policies set by the Central Bank	F	132	17	11	10	1	3	174	956
	P	75.9	9.8	6.3	5.7	.6	1.7	100.0	
The amount of fund available	F	18	63	25	32	31	5	174	686
	P	10.3	36.2	14.4	18.4	17.8	2.9	100.0	
Risk of finance methods	F	8	29	62	48	26	1	174	638
	P	4.6	16.7	35.6	27.6	14.9	.6	100.0	
Profitability of finance methods	F	6	35	44	57	30	2	174	620
	P	3.4	20.1	25.3	32.8	17.2	1.1	100.0	
The activity type	F	10	27	32	24	74	7	174	550
	P	5.7	15.5	18.4	13.8	42.5	4.0	100.0	
Other	F	0	3	0	3	12	156	174	204
	P	0	1.7	0	1.7	6.9	89.7	100.0	

⁴ The question was not applicable for 169 of the respondents.

Table 9.16 Friedman Tests Results and Mean Ranks for the Factors Influencing Distribution of Funds Decision

	Mean	Mean Rank
Credit policies set by the Central Bank	1.5057	1
The amount of funds available	3.0575	2
Risk of finance methods	3.3333	3
Profitability of finance methods	3.4368	4
The activity type	3.8391	5
Other	5.8276	6
Chi-Square Friedman Test 484.082 Df 5 Asymp. Sig. .000		

Therefore, we can conclude that the most important factor influencing distribution of funds is credit policies set by the central bank followed by the amount of funds available.

Hence, it is necessary to institute a dialogue with the central bank to design separate and different rules and regulations for supervising *musharakah* so as to facilitate and encourage banks to use this mode of finance. It is important, therefore, to study the credit policy to see how it effects the decision on distribution of available funds among various modes of finance.

Giving the results shown in the 9.15 and 9.16, it is necessary to identify the role which has been played by the BOS in controlling financial instruments including *musharakah* in the period 1990-2005 as well as the size of banks.

9.4.4 Credit Policy Set by the BOS

The Bank of Sudan annually sets the objectives of financing policies, and rules governing extension of banking finance, as well as liquidity management through setting and monitoring quantitative monetary targets such as *murabahah* margins, setting the minimum ceiling for *murabahah* finance and setting entrepreneurs' share in *musharakah*, administrative margins under a *murabahah* contract and setting the minimum ceiling for the partner to invest within any

murabahah project (Ibrahim, 2006). These tools are discussed in the following sections.

9.4.4.1 Controlling *Musharakah* Finance

The central bank has the authority to change the return on partnership projects by altering the ratios in which the bank and the entrepreneurs are expected to share the capital and consequently the profits and losses that are associated with the transactions. To achieve its policy, the central bank has control over the supply of high-powered money, the reserve ratios on the different types of liabilities, and the maximum amount of assets, which the banks can allocate to their profit sharing activities.

Overall for the period 1990-2005, as table 9.17 depicts, we see a gradual increase in the minimum percentages of the capital sharing of the customers in *musharakah* projects. For instance, for internal trade, it comprised 50%, 55%, 60%, and 70% for the period beginning 1993. For the priority sectors during the same period, it was 20% for three years, which then increased to 25%, and then up to 40%. It should be noted that the same gradual increase exists in regard to financing the production sector. This may indicate an intent to discourage using *musharakah*. It may indicate also that *musharakah* is preferred by the customers, for that reason and in order to control the money supply and demand, the central bank issued such policies. However, more formal statements of the Bank of Sudan's policies start with a number of guidelines or rules, one of which is the bank's duty to encourage. The minimum percentages of the capital sharing of the entrepreneurs in *musharakah* projects for internal trade is considered the highest among all other kind of *musharakah* as the BOS wanted to reduce the internal trade though *musharakah*. For instance the minimum percentages of the capital sharing of the entrepreneurs in *musharakah* projects in internal trade were 50% and 55% in 1992/93 and 1993/94 respectively. Then it jumps to 75% and 60% then 80% in 1995, 1996 and 1997 respectively. By contrast, the percentage for financing *musharakah* in the co-operative sector for production were between 10-45% for the whole period compared with 25-55% for the co-operative sector

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for non productive purposes. The percentage for financing the priority sectors were in general between 20-45%

While specifying a percentage for the capital share for financing professionals, craft makers, and small producers including productive families started after the mid nineties, starting from 1999 the percentage in all sectors has been left to individual banks to decide.

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Table 9.17 Minimum Percentages of the Capital Sharing *Musharakah*

year	Sector financed	The percentage of minimum capital provided by the partner
1990 - 91	Internal trading	25%
	Co-operative sector and federal state finance	10%
	Other sectors	Should be specified by the individual bank
1991 -92	Internal trading	25%
	Co-operative sector and federal state finance and priority sectors except import	10%
1992 -93	Internal trade	50%
	Priority sectors	20%
1993 - 94	Internal trading	50% of the Good's price
	Priority sectors	20%
	Non Priority sectors	50%
1994 - 95	Internal trading	55% then changed to 75% for the last four months
	Priority sectors	20%
	Cooperative sector for the production purpose	15%
	Cooperative sector for the non production purpose	25%
July to Dec 95	Internal trading	55% then increase to 75% in the last 4 months
	Priority sectors except export	25%
	Cooperative sector for the production purpose	20%
	Cooperative sector for the non production purpose	30%
	Export sector	25%
	Professionals and Craft makers	15%
1996	Internal trading	60% then changed to 70% in the last 6 month
	Priority sectors except export	25% changed to then 35% in the last 6 month
	Export and Cooperative sectors for the production purpose	20% then changed to 30% in the last 6 month
	Cooperative sector for the non production purpose	30% then changed to 40% in the last 6 month
	Professionals	15% then changed to 25% in the last 6 month
	Small producers including productive families	10% then changed to 20% in the last 6 month
1997	Internal trading	75% then changed to 80% starting from May
	Priority sectors and Export Cooperative sectors for the production purpose	40% then changed to 45% starting from May
	Cooperative sector for the non production purpose	50% then changed to 55% starting from May
	Craft makers and professionals	30% then changed to 35% starting from May
	Small producers including production families	25% then changed to 30% starting from May
1998	Internal trading	70%
	Priority sectors	36%
1999 - 2005	All sectors	Percentages were left to the individual banks

Source: (Bank of Sudan, 1990-2006)

9.4.4.2 Controlling *Murabahah* Finance

Murabahah was regulated by using a policy that set the minimum ceiling for the partner to invest. Then another policy, the maximum profit margins policy, was added in 1995. Table 9.18 and 9.19 depict both the increase in the first instalment percentages as well as the decrease in the maximum profit margins percentages for *murabahah*. In general, the table 9.18 and 9.19 indicate the goals of these policies, one of which is to discourage the customers from using *murabahah* and to persuade them to move to other finance methods. That is more obvious when we see that the use of *murabahah* or *salam* in the internal trade was prohibited during this period (Bank of Sudan, 1990-2006). This policy did not meet with much success. One can notice that 1999 was the first year that these policies were left to negotiation between the bank and the customer in these finance methods as well as the marketing of banking services (Ahmed, 2003, Ahmed, 2004).

The average minimum ceiling for the partner to invest within any *murabahah* project in priority sectors, cooperative sector for production purposes and cooperative sector for non-production purposes were 25%, 10% and 25% respectively. The minimum ceiling percentage for *murabahah* in internal trade is less compared with the capital share percentage in *musharakah* in internal trade as the average for the minimum ceiling for *murabahah* was 25% in 1990-1992, which was then left to the banks to decide thereafter. This indicates that the BOS is pushing banks to use *murabahah* in internal trade. Starting from 2001 the percentage in all sectors has been left to individual banks to decide.

After 1995, BOS depended on profit margins to control *murabahah* more than the minimum ceiling. The range for *murabahah* profit margins in priority sectors were between 30% - 45% in 1990s and 18% - 15% after 2000. After 2002 the percentage in all sectors has been left to individual banks to decide.

Changes in the *murabahah* profit margins, however, introduce some risks in the earnings of Islamic banks' activities. Islamic banks use this profit margin rate to

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price different financial instruments. Specifically, in a *musharakah* contract the feasibility of project proposals are decided according to the current mark-up margin. Since *murabahah* is less risky compared with *musharakah* and the contract and profit is known and predetermined and guaranteed before hand, therefore the profitability of *musharakahs* are expected to be bigger (Chapra and Khan, 2000). As a result Islamic banks face risks arising from movements in market *murabahah* margin rates.

Table 9.18 Minimum Ceiling for *Murabahah*

Year	Sector financed	The minimum percentage of the <i>murabahah</i> first advance instalment per year
1990/91	Internal trading	25%
	Co-operative sector and federal state finance	10%
	Other sectors	Should be specified by the individual bank
1991/92	Internal trading	25%
	Co-operative sector and federal state finance and priorities sectors except import	10%
1992/93	Priority sectors	25%
1993/94	Priority sectors	25%
1994/95	Cooperative sector for production purposes and craft makers sector	15%
	Cooperative sector for non production purposes	35%
	Other priority sectors	25% then increase in the last four months to 75%
1996-1999	—	—
2000	Agriculture, , industrial, export, professional, craft makers and small producers	25%
2001-2005	All sectors	Percentages were left to the individual banks

Source: (Bank of Sudan, 1990-2006)

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Table 9.19 Profit Margins for *Murabahah*

Year	Sector financed	The maximum profit margins per year
1995	Priority sectors	36%
	Craft makers	25%
	Small producers	15%
	Cooperative sector for production purposes	25%
	Cooperative sector for non production purposes	36%
1996	Agricultural, Industrial and Export sectors	30% then 35% for agriculture and 40% for export in the last 6 month
	Other priority sectors	36%
	Professionals, crafts maker and small producers	20% then 30% in the last 6 months
	Family producers including productive families	15% then 20% in the last 6 months
1997	Agriculture, industrial and Export sectors and other priority sectors	40% then changed to 45% starting from March
	Professionals and craft makers	35% then changed to 40% starting from March
	Small producers including productive families	30% then changed to 35% starting from March
1998	Priority sectors	36% changed to 30% after one month
1999	-	-
2000	Agriculture, , industrial, export, professional, craft makers and small producers	18% then changed to 15% starting from May
2001	All sectors	12%
2002	All sectors	12% - 15%
2003	All sectors	12%
2004	All sectors	10%
2005	-	-

Source: (Bank of Sudan, 1990-2006)

9.4.4.3 Controlling Small and Medium Enterprises (SMEs) Finance

In general, most of the difficulties in obtaining finance for small and micro enterprises (SMEs) are related to transaction costs, namely the cost of administering and delivering of credit and the cost arising from the risk of default. That is why bankers consider SMEs as risky clients since they do not keep proper records or meet conventional security requirements, and hence they are not bankable. Literature encourages private banks to extend credit through various risk guarantee measures. Others argue that these measures may involve 'moral hazards' as a result of financial institutions passing on the losses to the government, rather than reducing the risk (Ibrahim and Vijaykumar, 2003)

Numerous examples, from many countries, and using a wide variety of methodologies, demonstrate that it is possible to lend poor people the very small amounts of money they need, without tangible security, at times and in places that are convenient to them, and at a price that the borrowers can afford, and which also makes the operation sustainable (Harper, 1994).

It is argued that by pooling resources in terms of capital and expertise with small enterprises, such as individual farmers, not only would the farmer benefit from an increase in the size of capital available, but would also gain efficiency by learning from the financier's expertise. In this way it is possible to alleviate long term poverty.

One important advantage of *musharakah* is that the entrepreneur does not have to contribute in cash to the proposed investment. The entrepreneur is rewarded for his entrepreneurship, since in relatively profitable ventures the return on investment is much higher than other modes of finance (Abdalla, 1997). Hence, *musharakah* financing looks promising towards small scale, rural development projects aimed at poverty alleviation.

Although there were a few rules before, the full recognition of the small enterprise sub-sector started with the 1994/95 Financing Policy. 'Craftsmen,

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Professionals and Small Producers including the Productive Families sector' is considered one of the priority sectors for banking finance. The Financing Policy of the 1990s, for the first time, included crafts as one of the priority sectors for financing. In addition, the 1990 Financing Policy stressed the importance of banks' financing to regional and backward areas and small enterprises (Bank of Sudan, 1990-2006). The successive financing policies determined the financing ceiling for priority between 90% to 95% of the total finance, without any breakdown for each sub sector. The financing policies for the period 1994 - 2002 included concessions and financing regulations to this sub-sector.

In the financing policies of 1994/95 and July-December 1995, the percentage of participation in *musharakah* finance granted to craftsmen or professionals must not be less than 15% of the bank's total funding. In the case of small producers the participation is left for mutual agreement between the bank and the partner. In the Financing Policy of 1996, the small entrepreneur's percentage of participation in *musharakah* must be 10%. For Craftsmen and Professionals, the percentage of participation is still 15%. In the 1996 Financing Policy, the percentage of participation for Professionals and Craftsmen was raised to 25%, and that for small producers was raised to 20%. In 1997, both participation percentages were raised to 30% and 25% for the partner's participation for Professionals and Craftsmen and Small Producers (including Productive Families) respectively. The partner's participation in 1998 was not less than 30%. Since 1999 it is left for each bank to decide (Bank of Sudan, 1990-2006).

To conclude, BOS financing policies were hindering the *musharakah* finance as well as SMEs finance throughout the last fifteen years. The tariff and fiscal policies of government were designed without taking into account the interests of encouraging *musharakah* finance and small enterprises. The State Bank of Sudan regulations required (especially between 1991 and 2000) higher percentages of entrepreneurs' shares for these enterprises to qualify for *musharakah* financing. Therefore, these regulations should be discontinued. It is possible to conclude that there is a need to end BOS discriminatory regulations.

9.4.5 Size of Banks

As far as the amount of funds available, the most significant problem is the banks' narrow capital, eroded by the high inflation of the past years. According to the BOS, 10 Sudanese banks are classified as undercapitalized, with capital adequacy ratios below 8%. Non-performing loans in the sector are also high, representing 18% of total loans (Bank of Sudan, 1990-2005).

Most of the Sudanese banks are extremely small and cannot remain serious players in the market as it continues to expand and attract large international banks. In order to remain competitive in a global sense, Sudanese banks have to reach mutual understandings to merge or cooperate. They also have to take fundamental strategic decisions about the type of banks they wish to become. The best future prospects may well be in specialization. Since smaller banks cannot diversify their assets portfolios as much as larger banks can, they need a larger amount of capital relative to their assets to inspire confidence in their viability as well as their ability to maintain their core operations over the longer term. For this reason BOS requires banks to either strengthen their capital or merge to ensure greater strength. Capital requirements also depend on the riskiness of the banks' portfolio of loans and investments. If the more risky PLS modes of *mudarabah* and *musharakah* constitute a greater part of banks' assets, the need for capital may be relatively larger to guarantee the full repayment of demand deposits and also the withdrawal of investment deposits. If, however, the less risky sales-based modes of *murabahah*, *salam*, and *ijarah* constitute a larger proportion, the need for capital may be relatively less. The probability of default also determines the quality of assets and therefore the size of capital, and until a consensus is reached on the imposition of a penalty on the defaulting party, banks may have to hold more capital (Chapra and Khan, 2000).

Researches indicate Sudanese banks are one of the least concentrated and the least cost efficient banks among Arab and Islamic countries' banks when comparing the concentration of asset size and liquidity of the banks with the population (Brown, 2003). Hence, it is necessary to remove the disadvantage of

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the small size of Sudanese banks by encouraging and facilitating the merger of a number of such banks so that an optimum size is attained. In the absence of an optimum size, their average overhead costs are high and it is not possible for them to diversify their risks or be able to compete successfully with large conventional banks which now start to open in the south of the Sudan (Chapra and Khan, 2000).

Since the mid-1990s there has been apparent progress in bank supervision and regulations. Small bank size and weak bank performance in the 1990s, in particular, contributed to heavy government intervention and regulations that shattered public confidence in banks in the early 1990s (Elhiraika and Ahmed, 1998). The BOS has begun to reduce financial restrictions and liberalise the banking system and banks have engaged in inter-bank market activities. Uniform accounting principles for all financial institutions in Sudan were introduced in 1998. Key items of the banks' balance sheets are monitored by the BOS and banks have to submit specific information to the BOS on a daily, weekly, monthly, quarterly, and annual basis.

Reports show that Banks' paid-up capital has considerably deteriorated as a percentage of total assets. Sudanese banks had a narrow capital base over the 1990s and the capital adequacy ratio was always below the international norm of 8%. In 1994, the BOS required that all banks should comply with the 8% risk-weighted capital requirement within three years. In 1996, only 13 banks out of 28 met the capital requirement. In 2000, 9 out of 26 banks still undercapitalised (Hassan and Hussein, 2003). The BOS encouraged undercapitalized banks to merge through voluntary bilateral agreements; alternatively banks have to increase their paid-up capital to SD 3 billion by the end of 2002. Eight banks are requested to increase their paid-up capital to SD 1 billion by the end of 2000, to SD 2 billion by end of 2001 and SD 3 billion by end of 2002. Banking finance (in real terms) declined by 46% in 1990-2000. The growth rate of banking finance to private and public sectors were 82% and 20%, respectively, over the 1990s (Hussein, 2003).

Chapter Nine Musharakah Finance in the Sudanese Islamic Banking System: Preference and Performance

To conclude, the banking sector is continuously under pressure to become more efficient. Bank supervision is being strengthened. Unifying bank accounting systems as well as regulations on capital adequacy ratios according to Basle standards have been introduced. A programme for the central bank to monitor non-performing loans on a monthly basis was established in 1999. A banking sector restructuring strategy was initiated in 2000 with the aim of strengthening the capital base of the banks. This will include restructuring and privatizing public banks; merging, liquidizing, or recapitalizing small banks; reducing non-performing loans; and improving loan evaluation. The share of non-performing loans is still high, and most banks did not fulfil the Basle requirements for capital adequacy by the end of 2001. One way of handling non-performing loans has been establishing the Bank of Sudan committees that negotiate directly with the banks' boards and directors about how to decrease the share of non-performing loans.

BOS initiated a reform programme to develop and restructure commercial banks (2006-2008). By the end of 2007, banks are expected to increase minimum capital requirements for commercial banks from SDD3 billion to SDD6 billion (US\$25 million) and increase the capital adequacy ratio from 8% to 12%. BOS requires banks to implement action plans to meet provisioning and capitalization requirements. Lastly, the BOS will encourage mergers of commercial banks according to specific guidelines. In order to permit screening of any merger/acquisition, we will carry out an evaluation of banks to identify their net worth and share value (IMF, 2006).

The main challenge for the banking sector is how to reform and restructure themselves to be able to cope with the very fast changing environment within the Sudanese economy and on an international level. The Sudanese economy is undergoing a very major transformation with the discovery of oil and resumption of foreign direct investment in a substantial way. This in turn will create new challenges for the banking sector regarding the demand for bank financing and services.

Chapter Nine Musharakah Finance in the Sudanese Islamic Banking System: Preference and Performance

After discussing the preference and performance of *musharakah* in Islamic banking system in Sudan, the next chapter, chapter ten, will identify the constraints and obstacles facing *musharakah* finance including the causes of non-performing *musharakah*, the lack of proper feasibility studies, factors determining the capability of the entrepreneurs to be offered *musharakah* finance, and measuring entrepreneurs' creditworthiness.

Chapter 10 Obstacles and Prospects for Equity Participation Finance (*musharakah*) in Sudan

10.1 Introduction

An Islamic bank being aware of the magnitude of risk, to which its finance is exposed, should not only study the project with utmost care to the finest details, but should also closely follow up the execution and render all the necessary advice and expert service needed, to its partners. Since efficient management in most developing countries is a rare commodity, Islamic bank found this practice quite rewarding (Al-Harran, 1993).

Although theoretically *musharakah* finance is very promising, the practice has revealed many constraints. Some examples of such constraints have been discussed in this chapter including the causes of non-performing *musharakah*, the lack of proper feasibility studies, factors determining the capability of the entrepreneurs to be offered *musharakah* finance, and measuring entrepreneurs' creditworthiness. In this chapter the researcher intends to discuss these constraints and obstacles.

10.2 Factors Causing Non Performing *Musharakah*

This section aims to identify the factors causing non-performing *musharakah* investment. Therefore, it aims to respond to the following research question:

Research Question (13) What are the perceived factors causing non performing musharakah investment? And how can Sudanese banks over come these factors?

Chapter Ten Obstacles and Prospects for Equity Participation Finance (musharakah) in Sudan

In macro-level analysis, normally, business as a whole is not expected to suffer losses, though individual firms may not always earn profits. Failure can be attributed to the lack of one or more of the success factors. Failure on the part of the bank to follow-up the operations closely may be because of distance; and the lack of marketing outlets and the inexperience of the entrepreneur; all factors that contribute to the failure of the financed project (EI-Bhasri and Adam, 1997). Some factors may be beyond the control of the bank or the partner, and may contribute to the project failure. These include social factors, which may be a particular problem for women entrepreneurs: divorce and husbands' intervention are known to be a source of risk to the business project in micro-finance (EI-Bhasri and Adam, 1997).

To identify the factor(s) which usually cause(s) the non-performing *musharakah* (non performing debts¹), respondents were presented with six possible factors, and were asked to rank them. The six factors are lack of proper feasibility studies, lack of following up projects, lack of customer's experience, lack of bank staff's experience, lack of proper risk management and measurement, and other factors. The descriptive results are presented in table 10.1 and the results of the Friedman Test are presented in table 10.2.

With a significant level of differences as shown by Friedman chi-square test, the descriptive results indicate that respondents placed highest weight on lack of proper feasibility studies (mean rank 1.96, 1260 points) since 51% of them voted for it while 23% of them voted for lack of follow up on the projects. Other factors like lack of customer's experience got less weight with 8% whilst the rest of the factors all together weighed less than 5% including lack of bank staff's experience.

¹ The term bad debts is well known but not quite valid for the *musharakah* case as no debts should have occurred between partners, therefore it should be called non performing *musharakah* investment.

Chapter Ten Obstacles and Prospects for Equity Participation Finance (musharakah) in Sudan

Table 10.1 Factors Causing Non-Performing *Musharakah*

Factors		Significance						Total	Weighted significance ² points
		Ranked 1 st	Ranked 2 nd	Ranked 3 rd	Ranked 4 th	Ranked 5 th	Ranked 6 th		
Lack of proper feasibility studies	F	128	49	42	18	12	1	250	1260
	P	51.2	19.6	16.8	7.2	4.8	.4	100.0	
Lack of follow up of the projects	F	58	52	61	55	21	3	250	1062
	P	23.2	20.8	24.4	22.0	8.4	1.2	100.0	
Lack of customer's experience	F	31	75	65	53	25	1	250	1031
	P	12.4	30.0	26.0	21.2	10.0	.4	100.0	
Lack of proper risk management and measurement	F	21	48	41	51	80	9	250	852
	P	8.4	19.2	16.4	20.4	32.0	3.6	100.0	
Lack of bank staff's experience	F	7	24	37	72	101	9	250	737
	P	2.8	9.6	14.8	28.8	40.4	3.6	100.0	
Other	F	5	2	4	1	11	227	250	308
	P	2.0	.8	1.6	.4	4.4	90.8	100.0	

Table 10.2 Friedman Test and Mean Ranks for the Factors Causing Non-Performing *Musharakah*

	Mean Rank	Mean	Std. Deviation
Lack of proper feasibility studies	1	1.9600	1.21172
Lack of follow up of the projects	2	2.7520	1.32117
Lack of customer's experience	3	2.8760	1.19765
Lack of proper risk management and measurement	4	3.5920	1.41192
Lack of bank staff's experience	5	4.0520	1.15526
Other	6	5.7680	.88391
N 250 Chi-Square Friedman Test 626.962 df 5 Asymp. Sig .000			

² Numbers weighted significance (points) column in the table are the number of votes that each factor received, ranked from 1 to 6. To estimate each factors' significance, the researcher has weighted each vote by points from 6 to 1, 1st rank has 6 points, 2nd rank has 5 points 3rd rank has 4 points 4th rank has 3 points 5th has 2 points, and 6th rank has 1 point. e.g. 128* 6 + 49*5 + 42*4 + 18*3 + 12*2 + 1*1= 1260.

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To conclude, the most important factors causing non-performing *musharakah* are the lack of proper feasibility studies and lack of follow up of the projects. Hence, the researcher studies below the non-performing *musharakah* and the lack of proper feasibility studies.

10.2.1 Non-Performing *Musharakah*

Neither the Sudanese banks nor the Bank of Sudan have an exact definition of non-performing loan or investment. The Basle Committee on Banking Supervision considers a default has occurred with regard to a particular obligor when one or more of the following events have taken place (Basle Committee on Banking Supervision, 2001):

- (i) It is determined that the obligor is unlikely to pay its debt obligations (principal, interest, or fees) in full;
- (ii) A credit loss event associated with any obligation of the obligor, such as a charge off, specific provision, or distressed restructuring involving forgiveness or postponement of principal, interest or fees;
- (iii) The obligor is past its due more than 90 days on any credit obligation;
or
- (iv) The obligor has filed for bankruptcy or similar protection from creditors

Notably, one of the main problems of *musharakah* is the non-performing debts affair that has delayed simply the process of pay back both to the investor and to the bank. The problems faced by *musharakah* are mainly risk; the report proves that the problem of delay is the biggest problem that *musharakah* faces because if these loans are not paid off in time, they accumulate.

It is practically impossible to start executing all elements of the project at the same time, and therefore a certain degree of coordination is very relevant. For example the devaluation of the Sudanese pound made it almost impossible for some projects, which were financed on a *musharakah* basis, to pay off the instalments due to foreign suppliers of the machinery. This delayed and reduced

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the level of income due to the bank and prolonged the period of repayment of the cost of the machines. The case might have been quite different with a traditional bank. It might have delayed payment, but not necessarily given a low rate of return. Unlike traditional banks, the anxieties of Islamic banks start after they give out funds for investments. The Islamic bank has to follow up the projects to which finance is provided to see that it has been spent in the proper way and that the project is well managed (Al-Harran, 1993).

The follow-up does not only ensure efficient utilization of finance and guarantee a sizable return on the investment, but also looks after the efficient performance of the concerned business. The *Faisal* Islamic Bank for example has unique experience in this area. At the start of its operations, the bank used to provide working capital to certain industries in the form of cash without having supervision over the performance of the relevant factory. The rate of return increased by about 10% when the bank started to send out its staff to supervise projects, to consult with the factory management on problems of purchasing raw materials at the right time, providing proper storage for both raw material and the finished product, as well as discussing problems of marketing the products. In addition the expenditure on supervision was only 1.5% of the capital invested (Al-Harran, 1993).

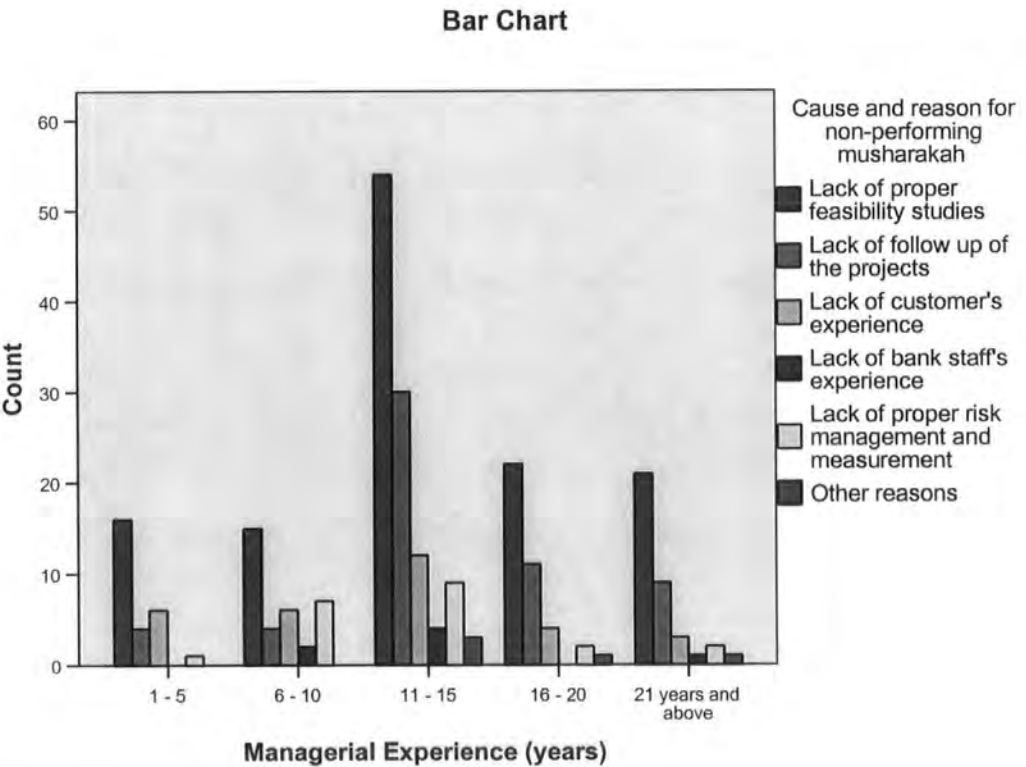
Do all respondents agree, regardless of their managerial experience without significant differences about the reason for non-performing debts? In other words, will the different type of managerial experience affect their responses to the reasons behind the non-performing *musharakah*. Table 10.3 shows the cross tabulation between the managerial experience and causes of non-performing debts, which suggests that there is a correlation between the managerial experience and the reason behind the non-performing *musharakah*.

Table 10.3 Cross Tabulation for Managerial experience

		Value	df	Asymp. Sig. (2-sided)
Factors causing the weakness of following up projects	Pearson Chi-Square	34.311(a)	20	.024
	Likelihood Ratio	37.417	20	.010
	Linear-by-Linear Association	1.719	1	.190
	N of Valid Cases	250		
	N of Valid Cases	250		

To illustrate, figure 10.1 demonstrates the distribution of the percentages of the different causes of non-performing *musharakah* amongst different managerial experience groups.

Figure 10.1 Managerial Experience and Reasons behind Non-performing Musharakah



It is clear from the figure that the lack of feasibility studies plays a big role in all managerial groups especially those who have 11-15 years of managerial experience. Similarly, those who have 11-15 years of experience place a big emphasis on lack of following up projects as a cause of non-performing *musharakah*.

10.2.2 Lack of Proper Feasibility Studies

When working capital financing is requested, sufficient information concerning insurance expenses, transportation costs, storage costs, etc., are collected. For example, in the commercial sector, the product turnover period becomes important as it influences the duration of the partnership contract. Another important factor is the sale mark-up used by the client-partner to sell the commercial product, as it determines the approximate ex-ante profit-sharing ratios as between the bank and its partner.

Usually there would be a greater number and variety of investment projects that would be seeking financing. As a result, more cautious, selective, and perhaps more efficient project selection by the banks and a greater involvement by the public in investment and entrepreneurial activities are needed.

Hence, there is no shortage of proposals for projects that have been identified but there may be a shortage of projects prepared in sufficient detail to permit implementation. Selection should be made based on economic and financial viability usually done through a feasibility study. The feasibility should clearly define the objectives of the project. It should explicitly address the question of whether alternative ways and methods of finance to achieve the same objectives may be preferable (Al-Harran, 1995b). Usually, when a project is proposed, a critical review or an independent appraisal would be carried out by going to the field which provides an opportunity to re-examine every aspect of the project plan to assess whether the proposal is sound and appropriate before a large sum of money is committed (Al-Harran, 1995b).

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Reports show that some Islamic banks have favoured members of the same political movement, and the political criteria carried more weight than the quality of the business proposal. For example in *Faisal* Islamic bank it was often enough that a senior member of the Islamic movement recommended somebody for finance. Members of the board of directors were among those who benefited, and the lack of normal procedure could go unchecked because of the FIB Act (Stiansen, 2004). Therefore the major challenge has not been the shortage of funds but rather the difficulty in identifying sound financing opportunities.

The criterion creditworthiness of the entrepreneurs indicates that the conventional banking system has to be changed to place more emphasis on the availability and profitability of projects. In addition to a term structure of rates of return, there has to be a structure of returns from different economics activities that banks have to consider. Project evaluation and appraisal, determination of profit sharing ratios, and the establishment of a procedural framework for the processing, monitoring, supervision, and auditing of various projects create new demands on commercial banks (Khan and Mirakhor, 1987). Hence, projects should be selected for funding through partnerships primarily on the basis of their expected profitability rather than the creditworthiness or solvency of the entrepreneur (Al-Harran, 1993).

Little effort, if any, is directed to collecting information about creditworthiness of the entrepreneurs. However, it may be emphasised that the researcher has only looked at one face of the problem. Sudan faces problems of enormous complexity and gravity. The need for a credit scores system and data base for the customers is urged at this stage.

10.3 Reasons for Weakness in Following up Projects From the Bank

This section aims to identify the reasons behind weakness in following up projects in *musharakah* finance. Hence, it aims to respond to the following research question:

Research Question (14) What are the perceived factor(s) that cause(s) weakness in the follow up process of musharakah projects? And how can Sudanese banks over come them?

To identify the factor(s) which usually cause(s) weakness in following up projects, respondents were presented with six possible factors, and were asked to choose the most important factor. The six factors are high cost of the follow up operations, non-cooperation from the customers or their refusal, absence of specialized departments for following up, weak or the absence of good incentives for those following up projects, the need for specialized and technical experience in some *musharakah* projects and other factors. The results related to distribution and significant points are presented in table 10.4. The results of chi-square Friedman test are presented in table 10.5.

The result of the Friedman chi-square test indicates that there is reasonable very low likelihood that the differences between the mean ranks in the sample data can be attributed to chance. The mean rank confirms the results derived from weighted significance points which on the other hand confirm the same ranking mentioned in the descriptive on table 10.4. The two tables suggest that the absence of a specialized department for following up is the most important factor with significant points of 1099 and a mean rank of 2.60. That is, 31.6% of the respondents ranked it first which can be compared with 20%, 20% and 13% who ranked it second, third and fourth. Concerning the second important factor the respondents believe that the need for specialized and technical experience is the second important factor causing the weakness of following up of projects, with significant points of 1040 and a mean rank of 2.82, since 24% of the respondents believe it is so. In addition, the respondents believe that the high cost of the follow up operations and the non-cooperation from the customers or their refusal

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is the third and fourth important factor, with a mean rank of 2.84 and 3.14 respectively, and with a percentage of 20% and 17% of the respondents respectively voting for them. In fifth place comes weak or the absence of appropriate incentives for those following up projects and lastly come the other factors.

Hence, to cover this obstacle the researcher studies the follow up, the need for specialized departments for following up and technical experience, supervisory process, setting a credit policy on every individual bank and training provided to staff.

Table 10.4 Factor(s) Causing the Weakness of the Follow up Process in Musharakah Projects

		Significance							Weighted significance points
Factors		Ranked 1 st	Ranked 2 nd	Ranked 3 rd	Ranked 4 th	Ranked 5 th	Ranked 6 th	Total	
Absence of specialized department for following up	F	79	51	51	34	29	6	250	1099
	P	31.6	20.4	20.4	13.6	11.6	2.4	100.0	
The need for specialized and technical experience	F	62	60	47	33	39	9	250	1046
	P	24.8	24.0	18.8	13.2	15.6	3.6	100.0	
High cost of the follow up operations	F	51	57	55	60	22	5	250	1040
	P	20.4	22.8	22.0	24.0	8.8	2.0	100.0	
Non- Cooperation from the customers or their refusal	F	44	42	58	52	49	5	250	965
	P	17.6	16.8	23.2	20.8	19.6	2.0	100.0	
Weak or absence of appropriate incentives for those following up projects	F	10	35	37	66	95	7	250	778
	P	4.0	14.0	14.8	26.4	38.0	2.8	100.0	
Other	F	4	5	2	5	16	218	250	322
	P	1.6	2.0	.8	2.0	6.4	87.2	100.0	

Table 10.5 Friedman Test and Mean Ranks for the Factors that Cause the Weakness of Following up Projects

	Mean	Std. Deviation	Mean Rank
Absence of specialized department for following up	2.6040	1.46141	1
The need for specialized and technical experience	2.8160	1.51238	2
High cost of the follow up operations	2.8400	1.34074	3
Non-Cooperation from the customers or their refusal	3.1400	1.42567	4
Weak or absence of appropriate incentives for those follow up projects	3.8880	1.24646	5
Other	5.7120	.92546	6
N 250 Friedman Test Chi-Square 491.383 df 5 Asymp. Sig. .000			

10.3.1 Following up

By sharing losses as well as profits, banks could function as absorbers of shocks stemming from the real sector and could thereby reduce the cost of adjustment. Since local entrepreneurs are hardly able to meet even temporary losses owing to their lack of resources, they may be overcautious in the implementation of projects that have a high expected return but high variability (Karsten, 1982). It seems likely that greater administrative resources would be required to operate a PLS system effectively than would be required for the effective operation of a traditional system, though it is to be hoped that the resulting higher costs could be offset, or more than offset, by improved allocation of investment. Greater involvement by institutional providers of funds in determining the uses to which such funds are put should have a positive effect (as the experience of western financial institutions seems to show). Still, the difficulties already alluded in finding a suitable means of providing and charging for short-term lending will need to be overcome if inflexibilities are not to hamper the smooth working of the financial system (Karsten, 1982). The limited evidence available demonstrates that Islamic banks have operated quite successfully during the past year.

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Banks do not manage firms on a day-to-day basis because it is too costly for outside investors to verify project returns and have to rely on the financial intermediaries. Financial intermediaries may arise to alleviate the information acquisition and enforcement costs of monitoring firm managers and exerting corporate control. Thus, this may deter insiders to misrepresent project returns to outsiders. Furthermore, in the case that entrepreneurs need to obtain funds from many outsiders, financial intermediaries can economize monitoring costs.

According to Diamond (1984) financial intermediaries reduce information and incentive problems by monitoring the entrepreneurs. Some monitoring takes place before a contract is signed and some takes place after the contract is signed. The former serves to reduce the proportion of bad loans and serves to improve the performance of a given contract. Therefore, monitoring is much more effective if delegated to the financial intermediaries. It is possible to conclude that the reduction in monitoring cost can foster efficient and long running investment (Ismail, 2006).

Following up projects entails additional cost for the banks arising from the cost of monitoring the joint venture. Moreover, the banks incur the training cost. They have to train their staff in the fields of planning and execution of the projects. Furthermore, following up is unsuitable for the businesses involving petty and repetitive transactions. It becomes too difficult to maintain the record of such businesses or even to properly monitor them. In spite of the above-mentioned weaknesses, following up is based on sound theoretical foundations. It can operate efficiently in a large number of enterprises belonging to various sectors of the economy (Akhtar, 1997). The experience of entrepreneurs, follow up by the bank, and availability of marketing channels mainly determined the success of these projects.

The application of *musharakah* in Sudan has singled out the high costs of following up and monitoring projects as major problems (Ibrahim, 1999; Harper, 1994). To reduce the administrative burden, branches have been created to serve limited geographical areas and are located around the business (Ibrahim, 1997).

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Musharakah returned a negligible portion of its operating costs, which are relatively high due to the level of monitoring the approach requires. Entrepreneurs would frequently claim business failures, but would be unable to provide substantiation of these claims. For example, a client would claim that an animal purchased with the capital had died, and that the cows had made off with the carcass.

The risk of fraud, which is especially worrisome to the regulators, seems to have two resources. One is the possibility of underreporting of profits earned by the firm. The second resource is the perception that since it is a PLS arrangement, the bank will have to carry the burden of potential financial losses. Thus there is an element of moral hazard in these transactions (Al-Harran, 1995a).

One factor that may increase the degree of risk is the lack of statistical data, such as profit distribution ratios among the parties involved in various trade, industrial, or service investment ventures.

However, there are at least three possible ways in which this residual risk can be minimized. The first is by faithfully implementing and observing the contract terms. Second is the possibility of third party insurance schemes with cost participation by the central bank and commercial banks. Third is maintenance of loss-compensating reserves by the banks. It must be noted that it is hard to finance using PLS without sufficient information regarding the managerial ability, competence and character of the entrepreneurs.

It is recommended to manage and monitor a specific number of *musharakah* transactions through a hired part-time manager whose cost is covered from the share of profit earmarked for management. After liquidation the same manager could monitor another set of *musharakah*. The bank, especially in Sudan, could create employment opportunities for unemployed graduates whose numbers increase annually as a result of expansion in higher education (approximately 30 universities were established during the last fifteen years) (Abdalla, 1999).

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Some Sudanese banks believe penalty on default payment may be charged by the Islamic Bank but the bank will not consider the penalty money as its income. The money may be used for charity. This is allowed only to force the customer to pay the instalment on time. Otherwise this penalty would not affect rate/profit of the bank profit distribution.

In this regards, the following steps are recommended:

- (i) Banks might accept to finance high risk *musharakah* on a selective basis to a number of clients, such as those whom the banks know have integrity beyond all doubts.
- (ii) In some sectors there is not much space for misconduct, negligence and dishonesty to work as an obstacle for financing through *musharakah* such as Export and Import. For instance, almost every essential thing will be known e.g. the exporter will have the specific order from abroad, the prices are agreed, the costs are not difficult to determine, payments are normally secured by a letter of credit, the payments are made through the bank itself. Similarly, financing of imports may be designed on the basis of *musharakah* with some precautions, as explained earlier. Therefore dishonesty will not be an obstacle to using *musharakah* instruments (Usmani, 2002).

These steps will serve as strong prevention against hiding the actual profit or committing any other act of dishonesty. Otherwise, the clients of the banks also cannot afford to show artificial losses constantly, because it will be against their own interest in many respects. It is true that even after taking all such precautions, there will remain a possibility of some cases where dishonest clients may succeed in their evil designs, but the penalizing steps and the general atmosphere of the business will gradually reduce the number of such cases.

To conclude, an Islamic bank should be aware of the magnitude of risk, to which its finance is exposed, not only studies the project with utmost care to the finest details, but also closely follows up the execution and renders all the necessary

advice and expert service to its partners. Since efficient management in most developing countries is a rare commodity, Islamic banks found this practice quite rewarding (Al-Harran, 1993). Hence, proper monitoring mechanisms are yet to be devised for PLS, especially in the case of *musharakah*, which does not provide any control rights to the financier.

10.3.2 The Need for Specialized Departments for Following up and Technical Experience

How far a bank can contribute effectively in running a project by itself can be primarily determined by the level of linkage it can establish through its financing mechanism. These are: project selection criteria; pre-financing appraisal of projects; post-financing supervision; built-in mechanical linkage of the bank to its financed projects (Sarker, 1999). Notably none of the Sudanese banks has specialized banks for following up projects. It is recommended to establish a section under the investment department or risk management department to be devoted to following up alone.

The roles expected to be played by the suggested specialized and technical department are:

- (i) Information systems and analytical techniques to measure the credit risk inherent in all activities;
- (ii) Setting the bank annual credit policy;
- (iii) Have in place a system for monitoring the overall composition and quality of the credit portfolio;
- (iv) Take into consideration potential future changes in economic conditions when assessing individual credits and credit portfolios;
- (v) Establishing a system of independent, ongoing credit review to evaluate the condition of the credit portfolio and performance of credit officers; and

- (vi) Ensure credit granting function is properly managed and credit exposures are within internal limits; credits exceeding predetermined levels to be monitored carefully

Each of the well-trained bank staff could handle a specified number of transactions annually. Hence, specification would contribute to efficiency of the bank and would expedite the completion of transactions.

10.3.3 Supervisory Process

Supervision is necessary to ensure the safety and soundness of the banking system as a whole and to ensure the protection of entrepreneurs. Supervision and follow up can be offsite *musharakah* projects or onsite.

For the purpose of follow up, Sudanese Islamic Bank uses both field follow up and office follow up. Field follow up, or personal contact, involves regular visits to the project by the bank representative to make periodic examinations of the partnership business records. Office follow up, on the other hand, is based on the reports and statements submitted by the entrepreneur.

Offsite supervision is mainly carried out on the *musharakah* project through meeting entrepreneurs and interviewing them as well as going through papers presented by the entrepreneurs including contractual requirements, legal covenants, policies, collateral etc. The purposes of the offsite are to

- (i) Assess the entrepreneur's compliance with banks regulations;
- (ii) Understand the entrepreneur's activities and risk profile;
- (iii) Probe the bank's management if "something odd" arises from the entrepreneur's regular reporting;
- (iv) Accuracy and timeliness of information provided to management information systems.

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In practice, the Sudanese banks don't carry regular offsite meetings. Interviews and off-site reviews should be periodical, since most of the projects are short-term ones and then it is advisable to have the offsite meeting at least once a month. These meeting are 'routine'; and tend to focus on analyzing regulatory reports, financial statements and checking if minimum requirements were met.

For supervision in the field staff should regularly visit the projects and check bookkeeping, marketing of products, account receivable and collection procedure. These arrangements tend to ensure the safety as well as the profitability of the bank's investment. The bank constantly watches its interest by focusing on the overall performance of the project. On-site inspections/audits are intended to:

- (i) Check in-depth an entrepreneur's financial position and current financial condition;
- (ii) Assess the quality of the entrepreneur's management and procedures.
- (iii) Review of functional activities;
- (iv) Use of approved credit (finance) lines; and
- (v) Adequate collateral coverage.

These occur through review transactions and processes, evaluate models, observation, discussing any obstacles and constraint facing the projects, and finalize financial analysis.

To conclude, more efficient supervision is needed because problems tend to be detected at an earlier stage. The supervisor can intervene or exert some pressure before the situation deteriorates. More specialised supervision is also needed. (Larger banks are supervised by more staff than smaller ones because they are systemic and more complex). Tailoring of regulations and requirements is also needed with the possibility of imposing tougher ones if needed.

10.3.4 Setting a Credit Policy for Individual Banks

Each individual bank should have its own annual credit policy which is not the case in Sudan; most of the banks don't have a clear credit policy. The credit policies should address target markets, portfolio mix, price and non-price terms, structure of limits, approval authorities. Banks should identify and manage credit risk in all products and ensure the risks are subject to adequate procedures and controls before being introduced and approved by the board of directors.

Banks should have a well-defined credit granting criteria that sets forth who is eligible for credit and how much, the type available and terms. Factors to be considered and documented in approving credits include:

- (i) The current risk profile of the entrepreneur and its sensitivity to economic and market developments;
- (ii) Credit risk strategy to include a statement of the bank's willingness to grant credit based on type (commercial, consumer, real estate, etc.), economic sector, geographical location, currency, maturity, and anticipated profitability.
- (iii) Credit risk strategy to include a statement of the bank's willingness to grant credit based on mode of finance type (*musharakah*, *murabahah*, *salam*, etc.).
- (iv) The proposed terms and conditions of the credit
- (v) Where applicable, the adequacy and enforceability of collateral or guarantees.
- (vi) The credit limits on single entrepreneurs and groups of connected entrepreneurs.
- (vii) A system of independent, ongoing credit review and the results of such reviews should be communicated directly to the board of directors and senior management.
- (viii) Identification of target markets and overall characteristics the bank wants to achieve in the credit portfolio.

10.3.5 Training Provided to Entrepreneurs

The individual entrepreneur's failure problem can be linked to the lack of entrepreneurs' experience. Some people's enterprises are bound to fail; many group-based programmes have an insurance fund of some kind, either formal, informal or both, to cover losses, but these are usually only available in cases of extreme hardship. For most poor people, business failure means the loss of livelihood and of the only capital which the owner possessed. This may lead to the discouragement of poor people to ask for finance (Harper, 1994).

By providing training to staff, banks will be able to help any entrepreneur including those who have had no previous contacts with a formal financial institution. However, the training is recommended for the entrepreneurs as well. Since the Islamic Bank is a real partner and is interested in achieving the best results for its entrepreneurs, the banks should provide its entrepreneurs with training in small business management; marketing policies and promotion; and quality and production control.

Unfortunately, the attitude of those who work in Sudanese Islamic banks or as consultants or extension agents has, more often than not, been inclined towards one of professional arrogance. Thus, an entrepreneur applicant is usually expected only to answer questions, not to participate actively in data analysis and budget preparation. Profit calculations and cash flow budgets are more likely to be in the filing cabinet of the financial institution than in the hands of the entrepreneur. This seems a wasted opportunity when the financial management skills of the clients could be enhanced by explaining and involving them in the calculations and decisions relating to their own businesses. Similarly in follow up visits to entrepreneurs there are opportunities to enhance learning by encouraging record-keeping and budgetary control measures as part of the loan review process.

-Training programmes targeted at rural people must implement training on issues of financial management such as regular recording of daily expenses and

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revenues, calculation of profit and losses, and keeping track of the dates and amounts of finance and repayment date. For the small entrepreneurs, focus should be on book-keeping, record-keeping and marketing, group management leadership training and community mobilisation and initial business appraisal and advice for all finance applications. Entrepreneurs need to properly diagnose the causes of non performing investment (formerly non performing debts) so as to learn and not repeat the same mistakes.

A consultancy or an advisory service may be introduced at the branches (perhaps through technical assistance) to help clients in identifying business opportunities, drawing business plans, preparing financial proposals, etc. Many donors would welcome a request for such assistance.

In addition, individual counselling can be introduced or one-to-one discussion which has many advantages as a means of adult training and education. It clearly addresses the unique needs and situation of the individual involved and enables the advisor or counsellor to take these unique circumstances into account when giving advice or information. The exchange of ideas that is possible in one-to-one discussions is very beneficial in helping people reassess situations and change their attitudes to problems and solutions. When dealing with money issues, these are intensely personal and few like to discuss their affairs in detail unless they are with someone they trust. Developing this kind of trust is possible with individual counselling. It is obviously possible to teach practical financial management skills like book-keeping in a one-to-one situation but it is costly in terms of time.

Where there is an ongoing dialogue between the financier and the entrepreneur, business decision-making is improved, as two parties working together produce a better outcome than when each is working in isolation.

10.4 Factor(s) Determining the Capability of the Entrepreneurs to be Offered *Musharakah* Finance

This section aims to identify the factors determining the capability of the entrepreneurs to be offered *musharakah*. Therefore, it aims to respond to the following research question:

Research Question (15) What are the perceived factors determining the capability of the entrepreneurs to be offered musharakah finance?

In an attempt to identify which are the most important, respondents were presented with five possible factors, that might determine the capability of entrepreneurs to be offered finance using the *musharakah* method, and were asked to rank them according to their importance. The five factors are customer's financial capability and current account movement, customer's financial history, customer's experience and type of guarantee provided by the customer. The descriptive results are presented in table 10.6 and the Freidman Test and the mean ranks are presented in table 10.7.

It is notable from table 10.7 that the difference apparent between the mean ranks is significant giving that the chi-square is equal to 0.00. Table 10.6 and 10.7 suggest that customer's financial capability is the most important factor with significant points of 1230 and mean rank of 2.08. That 39% of the respondents ranked it first which can be compared with 27% and 22% who rank it second and third respectively. Concerning the second important factor the respondents believe that the customer's experience is the second important factor with significant points of 1132 and a mean rank of 2.47. In addition, the respondents believe that the customer's financial history is the third important factor in determining the entrepreneur's capability before being offered *musharakah* finance, with significant points of 1112 and a mean rank of 2.55. The type of guarantee came fourth, followed by references taken about the customer. Hence, in the following section the researcher studies the customer's financial capability and measuring entrepreneurs' creditworthiness.

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Table 10.6 Factor(s) Determining the Capability of the Entrepreneurs to be Offered *Musharakah* Finance

		Significance						Weighted significance points
Factors		Ranked 1 st	Ranked 2 nd	Ranked 3 rd	Ranked 4 th	Ranked 5 th	Total	
Customer's financial capability and current account movement	F	97	69	56	23	5	250	1230
	P	38.8	27.6	22.4	9.2	2.0	100.0	
Customer's experience	F	65	69	62	41	13	250	1132
	P	26.0	27.6	24.8	16.4	5.2	100.0	
Customer's financial history	F	73	45	66	53	13	250	1112
	P	29.2	18.0	26.4	21.2	5.2	100.0	
Type of Guarantee provided by the customer	F	15	52	54	94	35	250	918
	P	6.0	20.8	21.6	37.6	14.0	100.0	
References we received about the customer	F	0	15	12	39	184	250	608
	P	0	6.0	4.8	15.6	73.6	100.0	

Table 10.7 Freidman Test for Factors Determining the Capability of the Entrepreneurs

	Mean Rank	Mean	Std. Deviation
Customer's financial capability and current account movement	1	2.0800	1.07621
Customer's experience	2	2.4720	1.18949
Customer's financial history	3	2.5520	1.25443
Type of Guarantee provided by the customer	4	3.3280	1.13205
References we received about the customer	5	4.5680	.83916
N 250 Chi-Square Friedman Test 389.210 df 4 Asymp. Sig.. 000			

10.4.1 Entrepreneur's Financial Capability and Guarantee Provided

Financial intermediaries can minimize the cost of acquiring and processing information about investment, which is costly if done by individual savers. Eventually, savings channelled through financial intermediaries are managed more efficiently. King and Levine (1993) state that the ability to acquire and process information leads to higher economic growth because intermediaries are capable of allocating funds to the most promising firm. In addition, financial intermediation can stimulate the rate of technological innovation by providing funds to entrepreneurs with the best chances of successfully initiating new goods and production processes. Here, the speciality of the financial intermediaries is to manage the deposit and at the same time allocate capital to entrepreneurs. However, if the role of financial intermediaries is as monitors and information specialists, then financial intermediaries tend to produce debt.

Theoretically, if the allocation of capital is based on the sharing of risk and profit, then, the actual performance of the project, enterprise or the economy as a whole determines the return on capital. Therefore, in this profit-sharing technique, the capital share profit is according to its actual realized productivity. The actual realized return on profit is thus the price of capital, which will determine its allocation (Ismail, 2006).

Profits produced in *musharakah* are not guaranteed; as a result, the entrepreneur does not assure, secure or guarantee profits. Fundamentally, no collateral is needed. It has been observed that the existing banking institutions prefer to grant credit facilities to those clients who apart from enjoying a good business reputation are also able to offer sufficient collateral security, mainly through valuable assets. This practice seems quite reasonable from the risk point of view, however, the non- tangible collateral holders are unjustifiably deprived of obtaining the necessary financial accommodation. The existing practice of demanding collaterals for the purpose of granting financial accommodation stems from the fact that Western Banking institutions are primarily concerned with profitability rather than the social imperatives. The imposition of tangible collaterals as a necessary condition left small businessmen and farmers trapped in a vicious circle: they cannot get access to finance

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unless they offer sufficient collaterals, they cannot possess tangible collaterals unless they build a strong productive base, they cannot improve their productive base unless they get access to finance, they cannot get access to finance unless they offer sufficient collaterals, So no solution for the endless, vicious and evil circle. Besides this, since you can get the credit as long as the risks are low and the capitals with its interests are well guaranteed, there is no real consideration for their management skills or the feasibility of their project (Hamid, 1991).

However, the bank (the financier) who usually does not perform to full management capacity, normally asks for a guarantee against any losses caused by the partner as a result of his mismanagement or negligence. Therefore, the customer might have to provide acceptable collateral, such as:

- (i) A real estate guarantee of the value equal to or more than the volume of financing.
- (ii) A bank ownership guarantee which is used when the bank finances a means of transport through diminishing *musharakah*, in which case the vehicle is registered as the property of the bank until the time when the partner has paid all the instalments.
- (iii) Two reputable guarantors (personal guarantee of a third), and he or she should sign promissory bank notes.
- (iv) In the case of financing raw materials, the bank usually supplies only part of the raw materials to the partner, depending on his or her payment of instalments (Ibrahim 1997).

On a theoretical level, entrepreneur creditworthiness and the guarantee provided is used to determine the foreseen risk brought up from the customer, since no strict security is demanded against the risk itself. Therefore, Islamic banks, theoretically, put great emphasis on the transaction, rather than the creditworthiness of the entrepreneur (Ibrahim, 1997). Hence, great attention will be drawn to the project and on studying its feasibility (Ibrahim, 2004). In case of any default, which is not the fault of any party, and the entrepreneur is unable to settle his/her bills, a grace period

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will be given without any additional fees. Any advancement demanded is made to cover the share of the partner in the venture and not as a security against losses.

These results raise a fundamental question of whether intangible assets such as education, experience, and skills can be as equal collateral as less tangible assets in reality. Would it be possible to consider the intangible assets? Can Islamic Banks balance the priority to the needs of society and the common interest with the individual profit and private interest?

Having had more than ten years using *musharakah* we should have had that balance. At least they have had to start concentrating on granting credit to educated talented customers with no collateral. The price, which might be paid when adopting the wide range of no collateral finance through *musharakah*, is high in cost and high in risks, as financing on the (un-granted) profit and loss sharing base will increase the risks and following up many financed projects will increase the costs. This is unless there is a developed risk management, efficient managerial staff who are trained and a proper follow up has taken place.

Another obstacle in the use of PLS is related to the way banks are looking at profit gain. Since profit is the main criterion to look into, banks will be tempted to finance high return projects, ignoring the socially beneficial projects. Hence, Islamic banks lack a social orientation, which seems to be necessary in all developing countries. The social benefits of ISBs cannot be fully utilized without the substantial use of the PLS mode of finance. Most of the limitations and obstacles outlined previously are products of weak experience of ISBs in applying PLS.

Group responsibility for repayment reduces default while such a grouping raises the size of finance and thus reduces administrative cost (Al-Harran, 1993). Fortunately this idealistic picture of co-operative societies has proved to be workable only in small and micro finance.

Grameen Bank in Bangladesh has developed a policy which states that in order to join the bank, the potential members have to choose the other members of their group, and

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the group will be penalized if any member fails to repay the current loan on time. In addition to weekly loan repayments, members are required to pay a small group tax and make small weekly personal savings into a group fund. Members are able to borrow from the group fund for consumption and investment purposes, with the agreement of the remaining members. If there is to be an expansion, it may be necessary to put more emphasis on professional managers and the use of modern management techniques. The crucial factor in the success of Grameen Bank is that it provides a system of assessing creditworthiness that is very cheap to operate since it shifts the risk of default from the bank to the potential borrower. This group lending has proved to be a success not only in Grameen Bank, but also in other institutions like PRIDE in Kenya and the Co-operative Bank of India in financing the Self Employed Women's Association (SEWA).

The usual situation is that a bank does not need to devote its time and energies to the task of assessing the honesty of customers for its loans as long as they can provide sufficient collateral to cover the loan. In contrast there are those who do not possess collateral to cover the loan, and therefore need to operate within a system in which their honesty can be tested.

Group collateral can serve a dual function of reducing the administrative costs and acting as a security against fraud and misuse of funds (Abdalla, 1997), hence, it is recommended a group leader, in collaboration with the bank's staff, should undertake the monitoring obligations (Ibrahim, 2004).

Alternatively, the combination of both the trustworthiness of the entrepreneur and the viability and usefulness of the project (i.e. towards the physical expansion of production and services) may encourage large and small entrepreneurs to venture into business with a greater possibility of getting financing from the Islamic banking systems.

The Sudanese Islamic bank had a successful scheme of *musharakah* for microfinance from which a lesson can be learnt. In the scheme the bank accepted personal guarantees, but did not ask for one in microfinance applications. The non-insistence of

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the scheme on physical collateral did not reduce the incentive of the banks. The substitute arrangements made by the banks ensured that the interest of the banks was not jeopardized. The arrangements included a selection of good partners and projects. Additionally, the marketable products of the project usually remained under the custody of the bank (storage of raw materials subject to partnership). Also, the banks could demand post-dated checks from the client by way of security. In addition, the staff regularly carried out field visits, which limited the chances of dishonesty such as unrecorded sales of the product under partnership, or tampering with records. In fact, the department responsible for the scheme was staffed with bankers and highly experienced and qualified technical staff. This department embarked on a number of innovations for entering the field of finance of rural agriculture, productive families and small enterprises.

These arrangements can adequately secure the capital of the banks (Akhtar, 1997). The scheme enables the small entrepreneurs lacking adequate equity and physical collateral to benefit from the finances and other services of the banks. The scheme provides an in-built indexation to counteract the effects of inflation and, as such, protects the interests of bank and borrowers. On the basis of similar arguments, the paper concludes that the scheme is viable and equitable (Akhtar, 1997). Unfortunately however, the scheme did not last and the strategy of the bank changed when the new management took over.

10.4.2 Measuring the Creditworthiness of the Entrepreneurs

This section intends to investigate the respondents' satisfaction with entrepreneurs' creditworthiness measurement. Therefore, it aims to respond to the following research question:

Research Question (16) To what extent are the respondents satisfied with their bank's methodology for measuring the creditworthiness of entrepreneurs and project related risks?

As shown in table 10.8 with a significant chi-square (Asymp. Sig. .000), 43% of respondents are to some extent satisfied with their bank's methodology for measuring

the creditworthiness of entrepreneurs and project related risk, which seems likely to be the main risk facing *musharakah*, but 24% on the other hand are not satisfied. This may lead to strong advice to review their bank’s methodology for measuring the creditworthiness of customers and project related risks.

Table 10.8 Satisfaction with Bank’s Methodology in Measuring the Entrepreneurs Creditworthiness

		Frequency	Percent
Satisfaction with their bank’s methodology for measuring the creditworthiness of customers and project related risks Chi-Square 13.592 Asymp. Sig. .000	Yes	79	31.6
	No	62	24.8
	To some extent	109	43.6
	Total	250	100.0

This degree of satisfaction is not acceptable. Banks should ensure that their methodology for measuring the creditworthiness of entrepreneurs and project related risks is of a high standard. In this regard it is crucial to make sure of the following:

- (i) The bank’s credit-granting activities conform to the established criteria;
- (ii) Written procedures are developed and implemented;
- (iii) Finance approval and review responsibilities are clearly and properly assigned;
- (iv) Banks should adopt regular measures of financial statement sheets, statistical data analysis forms, and the internal and external audit measures for the project financed;
- (v) Banks should also gradually implement the BAZL Committee measures for the control of various risk aspects;
- (vi) Banks need to manage the credit risk inherent in the entire portfolio as well as the risk in individual credits or transactions;
- (vii) The bank, from previous track records, can classify its clients into categories. It is proposed that the selected category of good clients form a “Bank’s Friends Club” which meets on a regular basis with the bank’s management and staff to discuss, as an unofficial advisory body, general

issues of mutual interest. This would serve to strengthen the bank’s relationship with the local community where it operates;

- (viii) Credit scores should be applied to measure entrepreneurs’ risks. It is worth mentioning here that there is an urgent need for a data system about entrepreneurs’ history and work, through credit scores to measure the risk brought from the entrepreneur. As, if any misconduct, dishonesty or negligence is established against a client in any bank, he might be subject to punitive steps, and may be deprived of availing any facility from any bank in the whole country, at least for a specified period. However such an approach is yet to be implemented in Sudan.

10.5 Other Obstacles Hindering *Musharakah* Projects

Table 10.9 presents the relevant importance of some selected obstacles facing *musharakah* finance. These obstacles are lack of funds, lack of managerial efficiency, lack of feasibility studies, lack of well experienced customers, and other obstacles. The results of the Friedman test and mean ranks are shown in table 10.10. With a significant level of differences indicated by the Friedman test. The descriptive analysis shows in table 10.9 that the most influencing obstacle is the lack of feasibility studies with a 1265 points and mean rank of 1.94. In addition, 38% of the respondents ranked it first and 36% ranked it second. The lack of well experienced customers, with a 1204 points and mean rank of 2.18, came as a second important obstacle followed by limited credit ceilings which has 1096 points and 2.62 as a mean rank.

Table 10.9 Obstacles Hindering Musharakah Finance

		Significance						Weighted significance points
Factors		Ranked 1 st	Ranked 2 nd	Ranked 3 rd	Ranked 4 th	Ranked 5 th	Total	
Lack of feasibility studies	F	95	92	48	13	2	250	1265
	P	38.0	36.8	19.2	5.2	.8	100.0	
Lack of well experienced customers	F	69	101	47	31	2	250	1204
	P	27.6	40.4	18.8	12.4	.8	100.0	
Lack of funds	F	61	37	97	47	8	250	1096
	P	24.4	14.8	38.8	18.8	3.2	100.0	
Lack of managerial efficiency	F	17	18	47	150	18	250	866
	P	6.8	7.2	18.8	60.0	7.2	100.0	
Other	F	8	2	11	9	220	250	569
	P	3.2	.8	4.4	3.6	88.0	100.0	

Table 10.10 Freidman Test and Mean Ranks for Obstacles Hindering Musharakah Finance

	Mean Rank	Mean	Std. Deviation
Lack of feasibility studies	1	1.9400	.92293
Lack of well experienced customers	2	2.1840	1.00108
Lack of funds	3	2.6160	1.13918
Lack of managerial efficiency	4	3.5360	.97391
Other	5	4.7240	.85013
N 250 Chi-Square Friedman Test 519.638 df 4 Asymp. Sig. .000			

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The argument presented here is that it is impossible to judge the risk of *musharakah* transactions in a bank’s portfolio without considering how the returns on these transactions compare with the rest of the bank’s returns, and that the effect on risk of adding a *musharakah* transaction to a bank’s portfolio is based on the comparison between returns on *musharakah* transactions and its overall portfolio returns (Mirakhor, 1987). This should be in mind when looking at any proposal and feasibility study for *musharakah* finance.

Since the importance of the feasibility studies is already presented, the following section studies the satisfaction with performance measurement systems and training provided to staff.

10.5.1 Satisfaction with Performance Measurement Systems

With a significant chi-square and as shown in table 10.11, 46% of the respondents are satisfied with their bank’s measurement systems for the performance of *musharakah* projects; whilst 38% of them are to some extent satisfied and only about 15% of them are not satisfied. As a result of this, it may be possible to conclude that a relatively simple majority of the respondents believe that the measurements of *musharakah* performance are quite satisfying and therefore there is no need to proceed further with substantial changes or improvement.

Table 10.11 Satisfaction with Performance Measurement Systems

	Valid	Frequency	Percent
Satisfaction with their bank's performance measurement systems for <i>Musharakah</i> projects Chi-Square 37.544 Asymp. Sig. .000	Yes	115	46.0
	No	39	15.6
	To some extent	96	38.4
	Total	250	100.0

10.5.2 Quality Training Provided and Managerial Efficiency

With a significant difference as indicated by the chi-square and as shown in table 10.12, 41% of the respondents assume that to some extent quality related training is provided for all employees, whilst less than 20% of them do not believe so while the majority of them (38%) consider that all employees have been provided with quality related training. It is worthwhile to restate that most of the respondents (86%) have attended investment training courses (Asymp. Sig. .000).

Table 10.12 Training Provided

		Frequency	Percent
Quality-related training is provided for all employees Chi-Square 20.216 Asymp. Sig. .000	Yes	97	38.8
	No	50	20.0
	To Some extent	103	41.2
	Total	250	100.0

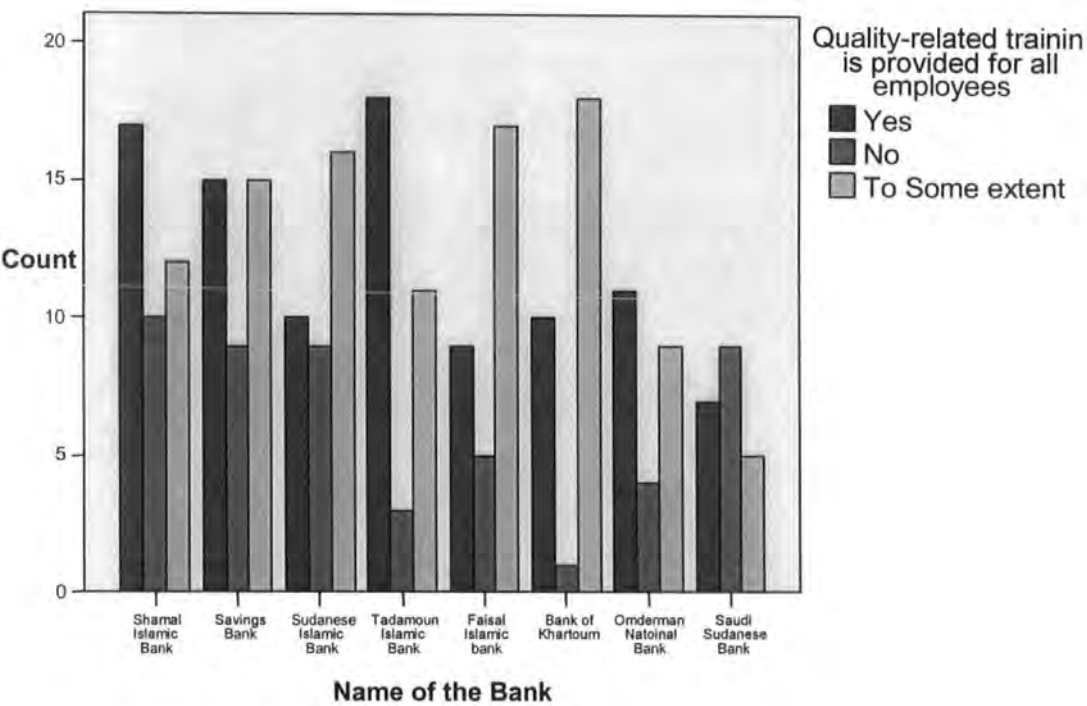
Table 10.13 depicts the results of the cross tabulation chi-square tests in which the results indicate that the quality related training programme is not provided with the same degree in all sampled banks. Some of these banks do provide some training programmes of a better quality compared with the rest.

Table 10.13 Cross Tabulation for the Different Banks and Quality-Related Training Provided

	Value	df	Asymp. Sig. (2-sided)
Pearson Chi-Square	25.785(a)	14	.028
Likelihood Ratio	26.591	14	.022
Linear-by-Linear Association	.349	1	.555
N of Valid Cases	250		

To illustrate figure 10.2 presents the different distribution of the quality training provided among different banks, which shows that *Shamal* Islamic Bank, Savings Bank, *Omderman* National Bank, and *Tadamoun* Islamic Bank offer more training related programmes compared with the remaining four banks.

Figure 10.2 Quality Training Programme Provided



Managerial efficiency is necessary for improving performance, especially for those projects which depend on follow up, management and control such as *musharakah* projects. Management is defined as the initiation of projects (demand and feasibility studies, project proposals and so on.) and the implementation of these proposals by an active involvement in the production process. Control, on the other hand, is defined as the right to ratify the initial proposals and supervise the projects either through internal monitoring or external mechanisms (Dar and Presley, 2000). Accordingly, the

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researcher may advise to strengthen the managerial efficiency of these banks. There is no doubt that bad debt rates for these methods especially nonperforming *musharakah*, can be an indication of managerial inefficiency, and failing to get funding from it can be seen as a sign of this inefficiency.

Efficient supervision over banking operations could have greatly reduced the problems, but efficient supervision requires the availability of trained bank examiners, controllers and supervisors, well-versed in the applications and operations of the new procedures and techniques, and thoroughly familiar with the theoretical and practical details of interest-free banking operations. Such expertise on a sufficient scale has been lacking and it may take many years for an efficient system of supervision to be satisfactorily installed (Najmabadi, 1999).

The Sudanese banks need to build stronger internal control mechanisms, as some of their problems are caused by internal factors. Hassan and Hussein (2003) argue that despite collaterals provided against finance, banks are not able to liquidate the collaterals. Other general problems such as a lack of professional, technical and managerial expertise have also resulted in the unsatisfactory performance. In fact to reduce costs in Sudanese banks there was a reduction in the numbers of staff and complementary services while no strengths were planned for the remaining staff.

Analysis based on the discussion with the Executives of the banks reveals that Sudanese banks make the utmost attempts to select efficient projects but they cannot supervise post-financing situations in most of the cases. That is why, good entrepreneurs diverted elsewhere and projects could be sick and affect recovery of finance. It is because of the fact that Sudanese banks mostly finance using the trade related modes that have little or no relevance to project financing. Arrangements at various levels have been slow in developing and demonstrating their usefulness to project management. This situation can be attributed to a number of reasons, such as a lack of trained monitoring and evaluation staff, lack of training facilities for new staff, and difficulties in retaining trained staff in the absence of good career development prospects (Al-Harran, 1995b).

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Better trained staff with appropriate skills to manage risk is a necessity for the survival of Islamic banks in the world market. In fact, PLS modes require greater supervision and monitoring operations. In this regard, the staff should be trained to ensure that the Islamic operations succeed as planned. The spread of bank branches must be well planned.

To conclude, appropriate training programmes need to be designed and adopted to upgrade the skills of staff and short training programmes for the target group need to be considered.

Chapter 11 Conclusion and Recommendations

11.1 Introduction

This research is aimed at introducing *musharakah* as a modern method of financing, without violating its basic principles in any way. I have introduced *musharakah* and have discussed basic problems which face its implementation in a modern situation. I hope that this discussion may open new horizons in the area of Islamic banking.

The application of Islamic partnership financing formulae, as discussed has not been without its problems. One reason for this is that Islamic banks have been created from scratch, with no past relevant experience in profit and loss sharing to learn from. As the researcher has shown, many problems remain to be resolved. A great deal of research is needed in the application of the PLS formulae if it is to become more widespread and successful. Yet, in the recent history of Sudan it is difficult to underestimate the overall impact of Islamic finance. This is because the political aspect has always been more important than the economic aspect of Islamic finance.

This study has highlighted that there is currently a large interest in understanding PLS finance, but little is known about its implications, which reveals many new and interesting findings about the implication of using *musharakah* mode of finance. It reinforces previous findings of the financing patterns of *musharakah*. It also adds to the debate over the benefit of using profit and loss sharing finance.

A number of rather powerful arguments have been presented in the last chapters, as a result of practical experiences, which demonstrate that there are many constraints in the adoption of partnership finance, so that its introduction, if it is feasible at all, is certainly not an easy matter. These constraints have been identified.

Chapter Eleven Conclusion and Recommendations

The purpose of this concluding chapter is to summarise and discuss the findings of this study and recommendation derived from these findings on theoretical, institutional, and practical levels. Also, questions arising from this study are used to propose an agenda for future research.

These conclusions may not be entirely new, but the way they have been deduced and given form here is probably fresh. Some of the assumptions of the *musharakah* model may not seem realistic. But they are of a simplifying nature. Their removal would complicate the analysis but would hardly affect its broad conclusions.

11.2 Findings of the Study

This section aims to summarise the important findings of this research in the following sections.

11.2.1 The Overall Performance of the Sudanese Economy and Banking as an Environment for *Musharakah* Financing

Over the nineties the economy of Sudan was characterized by severe macroeconomic instability as indicated by high and accelerating internal and external imbalances, rapid exchange rate depreciation. On average, all macroeconomic indicators worsened during 1990-1998. However, the current economic situation within Sudan is much better than it was in the late 70s, 80s and 90s. Sudan's economic performance in recent years has improved with robust growth and single-digit inflation levels. In addition, important economic reforms were undertaken. The authorities attained macroeconomic stability, lifted price controls, set up liberal foreign investment and foreign exchange regimes, pursued an ambitious privatization and enterprise-restructuring programme, and began a second phase of reforms to liberalize the trade regime (IMF, 2006).

The dramatic change in the performance of the Sudanese economy since 1998 could be attributed to a number of factors that include: (1) economic reforms; (2) favourable weather conditions affecting agriculture; and (3) high investment in

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oil sectors and related services. While the stabilization measures and economic reforms have been carried out without external aid or technical assistance and achieved success in setting high growth rates for the economy, external debt and its accumulated arrears remain to be a problem facing future development of the country.

Some conclusions can be derived from the discussion about the overall performance of the banking system in Sudan. First, the reasonably high growth in the volume of deposits and increase in the ratio of total deposit-to-GDP over the last years signal a stable confidence in the banking system. The low ratio of credit to GDP 1990-2000 reflects the difficulties SIBs in Sudan are facing providing funds for development. Similarly, the finance sector has witnessed dramatic increase in levels as well as a percent of GDP, deposits and assets. Second, sectoral concentration of investment is not evenly distributed and is biased towards the modern most profitable sectors, including trade, modern agriculture, and industry. Third, the banking sector has undergone substantial liberalization, privatization and restructuring and increase in bank capital and reform in supervision and regulative environment. Moreover, the BOS has been active in the last few years in strengthening prudential supervision and reforming the banking system, tightening the banks' large share of non-performing loans, enhancing profitability, restructuring of banks and increasing the banks' capital, restructuring the loans portfolio, and addressing the difficulties facing them. Lastly, giving these financial performances demonstrated, Sudanese banking finances are not expected to be considered effective for high risk operation nor poverty mitigation and financing micro-enterprises, as its performance and banking indicators are poor.

As far as the monetary and credit policies are concerned, in the absence of a well developed money market, in the last 15 years the BOS issued policies including three main components: the credit ceiling which consists of stipulating the share of some economy sectors of the overall finance; the minimum capital for entrepreneurs in a *musharakah* contract; and minimum credit ceiling paid by the customers in a *murabahah* as a percent of the total price of the goods, the

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maximum profit margins charged by banks in a *murabahah* and setting the share of the priority sectors over the total banking finance.

The BOS usually imposed detailed requirements for banking finance, dividing the economy into priority sectors and sub-sectors for which the banks were required to extend credit. Financing agriculture was a priority, other sectors were less of a priority, and some were prohibited from bank financing.

Selective methods of credit control are used to affect the direction of credit and certain guidelines are provided to allocate available credit to different sectors. In the present credit policy sectors, exports industry, agriculture, handicraft and medium and long term investment projects are identified as priority sectors. A minimum of 80% of total credit provided to sectors other than the priority sectors may not exceed 20% of the credit ceiling approved for the bank (BOS, 1990-2006; BOS, 1990-2005).

The financing regulations of the Bank of Sudan are still under modification, and lacks proper identification of the *musharakah* share of banking finance despite more than 15 years having passed since 1990, namely the second Islamization period in banking industry (Ahmed, 2004).

11.2.2 Distribution of Finance by Mode of Finance

The results presented in this study demonstrate that the Sudanese banks prefer *murabahah* over other types of Islamic modes of finance, as the results show *murabahah* had the biggest share of the fund with an average of 47.3% in the overall funds. *Musharakah* is also a popular form of finance among Sudanese banks with an average share of 29.3% of total finance. Due to the increase in non-performing loans in agriculture, banking finance through *salam* contracts declined from 22% of total banking finance in 1992 to 2% in 2005. Other modes of finance constitute a small fraction of total finance.

In reflecting on the results, it should be mentioned that the *mudarabah* has never been of more than marginal importance. However, there are many reasons why

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mudarabah does not play as large a part as *musharakah*. Because, *mudarabah* in Sudan works mainly on trade and *mudarabah* application is confined only to a small number of well-trusted clients with a good track record, usually well known to the financiers. *Salam*, *mudarabah* and other methods achieved on average 6.5%, 4% and 13% respectively. In general, it can be noticed that there is a gradual increase in *musharakah* funds as it started with 15% in 1990 and increased to 32% in 2004 compared with a gradual decrease for *murabahah* which started with 70% in 1990 and ended at 38% in 2004. In fact in 2000, *musharakah* reached its peak by holding the largest share: 43% compared to 33% for *murabahah*.

It can also be noted that government pressure has been the major factor behind this shift towards more *musharakah* finance. Two objectives have guided government policy in this regard. First, aiming at reducing what *de facto* was the continuation of interest-based lending through widespread use of synthetic *murabahah* contracts. Another aim has been to increase long-term finance. Some bankers have expressed strong reservations about the government's preference for the *musharakah* contract, because they see this contract as much more risky than the *murabahah* that commonly can be secured against liquid assets. Other reasons behind the shift are first: risk, difficult nature of investment and long-gestation period in receiving returns and problems of management. Instead they use mostly debt-based *salam* and *murabahah* instruments, which shift most of the risk to the client. Secondly, *musharakah* modes require adequate experience in management, additional supervisory and monitoring roles compared with sales-based modes which are relatively easy to manage. Thirdly, the simplicity of the *murabahah* mode and the people's preference, it's suitability for short term finance compared with *musharakah*. Lastly, PLS contracts are inherently vulnerable to agency problems, because entrepreneurs have disincentives to put in effort and have incentives to report less profit compared to the self-financing owner-manager.

11.2.3 Short Term *Musharakah* Finance

With a significant difference the dominant type of *musharakah*, lasts for 3 to 6 months as reflected by 72% of the respondents. Two parties share financial resources without participatory decision-making. The results indicate that the correlation between *musharakah* risk and the average age of *musharakah*, with a significance chi-square which states that the degree of *musharakah* risk has influence on the average age of *musharakah*. The nature of the short term deposit at Sudanese banks is the main reason for preferring short term finance. The advantages of using a short term *musharakah* strategy are a broader portfolio diversification, which can reduce risk for a given return or increase return for a given risk; the ability to participate in new risks, including new projects; and rapid capital turnover.

However, the researcher argues here that one of the major dilemmas facing the present Sudanese Islamic banks is the fact that these banks have to involve in long term finance according to its theory where these banks mobilize funds on the basis of short term deposits. Facing all the economic and political barriers confronting the country, such as high inflation rate due to external factors, as well as internal factors such as small size of the capital and lack of managerial efficiency, Sudanese Islamic banks have to be involved in long-term finance.

11.2.4 Discussing the Expressed Preferences

11.2.4.1 Preferred Instruments

The results show that there is reasonable very low likelihood that the differences in the Islamic finance methods preference in the sample data can be attributed to chance, implying that in most of the cases the differences are statistically significant. Most of the respondents prefer *musharakah* as their mode of finance in dealing with their customers. As almost 60% of the respondents preferred *musharakah* and by contrast only about 35% of them selected *murabahah*, whilst less than 3% chose the *salam* mode of finance and less than 3% of the

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respondents selected other modes of finance including *mudarabah*, *istisnaa'*, *muzarahah* and *mosagah*. This may show the support of the banks' employees to *musharakah*. Stated preferences, however, are not necessarily reflected in actions. To some extent these preferences may be the result of an awareness of Islamic finance. In Sudan, some clients who reject interest-based loans may be sceptical about *murabahah*, with its strict collateral requirements which bear an apparent similarity to interest-yielding loans. Such clients may welcome *musharakah*, which minimizes the pressure exerted on clients by the financier. However, in big businesses, especially lucrative ones, some clients would prefer *murabahah* because they would know in advance the exact amount they will pay as a profit margin and at the same time keep banks away from direct intervention in their businesses. On the other hand, banks would prefer *musharakah* since the end return on investment would be higher. In non-lucrative businesses this scenario is reversed. Banks would choose *murabahah*, especially when dealing with risky small businesses.

In order to see whether there is a relation between the mode of finance preferred and the degree of profitability and risk signed for these modes by the respondents the chi-square cross tabulation test was run. The results confirm that the degree of profitability and risk correlate with the mode of finance preferred with significant difference.

11.2.4.2 Preferred Economic Sector

The analysis indicates that there is a difference in reaction towards different finance sectors. The industrial sector came as the first important sector which should get *musharakah* finance followed by the commercial sector. The export and import sector came in third place followed by the agricultural sector. Stated preferences, however, are not necessarily reflected in actions. To some extent these preferences may be the result of an awareness of the rise in Islamic fundamentalism. In reality the commercial sector takes most of the *musharakah* fund.

11.2.4.2.1 Industrial Sector

In the case of financing the industrial sector through *musharakah*, the Sudanese banks provide capital to the owners of the industries, and the owners, on the other hand, contribute with their industry, labour, part of the running expenses and management. The industrialist also gets a proportion of the net profit for his management, and the remaining profit is divided between the bank and the industrialist according to their equity share. Through *musharakah* contracts, the Sudanese banks succeeded in providing capital to the industrial sector for the purchase of raw materials, machinery and equipment. Moreover, SIBs diversified their industrial investments. These included food factories, plastic factories, printing presses, drugs' factories, spare parts for petroleum refinery, sugar factories, and railway corporations. In addition, they enhanced the small-scale industries in Sudan which are believed to play an important role at the present, as they are a more labour intensive stage of development. The SIBs opened specialised branches in one of the biggest industrial areas in Khartoum to develop the handicraft sector.

11.2.4.2.2 Agricultural Sector

In the case of financing the agricultural sector, the SIBs provide the machinery (tractors, water pumps, spraying equipment etc.) and provide its contribution in the form of services that are complementary to what the farmers provide in a joint effort on the basis of real, not commercial, costs. Usually the SIBs provide ploughing and irrigation services inputs such as improved seeds, insecticide, fertiliser, jute bags delivered at the gate of the farm, working capital, agricultural extension services, storage and marketing, marketing partnership. The entrepreneur, on the other hand, contributes with his land, labour, part of the running expenses and management. The farmer gets a proportion of the net profit for his management and the remaining profit is divided between the bank and the farmer according to their equity share. The instruments include co-farming, co-irrigation, lease of machinery, and agricultural and marketing services. For instance, SIBs executed a number of projects at different places in Sudan with

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substantial benefits to itself and the farmers. The bank provided machinery and other service inputs in these projects, while farmers provided land and operating expenses. The farmer nurses the plant until it is ready for harvest. When the crop is collected, it is not sold immediately. This is because at the beginning of the harvest season the prices are usually on the low side. Under normal circumstances, farmers used to sell their crops to merchants who take advantage of the farmers' need for cash after harvest. These merchants purchase the crop at a low price, and they store it until the price improves and, therefore, are the main beneficiaries of the farmers' effort. In this formula, the SIBs store the crop after harvest and help the farmer by giving him part of the estimated share of the crop in order to meet his urgent needs. Then, when prices increase, the crop is sold with the knowledge of the farmer.

11.2.4.2.3 Trade Finance

The results indicate that 41% of the respondents believe that the rapid turn over of the capital in trade is the reason behind the preference of trade finance, while 35% of them refer it to the high profit margins of the trade sector compared with other sectors. Other reasons, like the low risk and inadequate capital for other non trading investments, got approximately 10%.

11.2.4.2.4 Co-operative and Small Producers Sector

Wider branch networks and ranges of banking services are a prerequisite for banks in order to reach a large number of entrepreneurs, through partnership formulae. Despite the prominent increase in the number of Sudanese banks and branches' in the 90s, it is described and characterized by the regional inequality in the distribution of branches, which clearly shows that the concentration of branches is in commercial towns compared with urban areas. Moreover, the pattern of distribution has been more or less the same for the last fifteen years or so. The lack of a co-ordinating mechanism between the banks themselves and other institutions concerned with small enterprise financing has created another

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important constraint, together with the lack of national policies specially designed and oriented towards Small and Medium Enterprises (SMEs). Recent national policies towards small enterprises and productive families have shown some positive signs.

Some Sudanese banks, however, have managed to employ Islamic formulae to finance small producers. So far these banks have fulfilled some expectations in small enterprise financing, though some difficult questions still need to be tackled. Moreover, the costs of continuous follow-up and the monitoring of projects are relatively high. To reduce the cost of follow-up, the SIB, for example, have created the small producers and families branches, SPFBs, to serve limited geographical areas and the bank is thinking of employing a third party to follow-up and share a certain percentage in the total profits.

Projects financed cover a wide range of small urban enterprises such as tailoring, food processing, shoe and soap making, chalk, cheese-making, goat and poultry-keeping, petty retail trade and some informal sector activities, such as *Kisra* (flat local bread) making. Business specialisation varies according to geographical location of the productive families' branches, with the concentration of foodstuffs at al-Thawra branch; sewing at al-Girsh model branch; poultry, cows, and goat keeping at Wad Medani branch. The experience of the Sudanese Islamic Bank has revealed some of the advantages of such non-traditional transactions. None of the partners who are financed could have previously gained access to such funding, had not the Sudanese Islamic Bank, especially Productive Families branches (PFBs) been available. Ordinary people in urban residential areas, especially women, can get access to conveniently located branches.

As a result of *musharakah* financing, trust is built between the bank and residents of the local community in which the bank operates. This could be further capitalised on by launching community based development programmes. One important positive aspect of *musharakah* is that no finance cost is added to the production cost. It can therefore contribute to lower prices in comparison to other methods of finance.

11.2.5 Performance Analysis

11.2.6 Profitability

The non-parametric test confirms that the profitability performance is not on the same level on all options according to the respondents views. The profitability of *musharakah* projects, as perceived, is high. As a result, on a whole 45% of the respondents consider the profitability of *musharakah* projects to be high, alongside 22% of them who believe it is very high, while only 8% believe it is low and 33% consider it to have acceptable profits compared with other projects financed using other methods. Accordingly, the researcher may sum up that the majority of the respondents believe that the projects financed using *musharakah* have a high profitability compared to their bank standards.

11.2.7 Risk

Significantly, almost one third (30%) of the sample respondents believe that the *musharakah* risk is high with an additional 28% who believe it is very high. In regards to those who consider *musharakah* risk is acceptable or low they were simply 24% and 14% respectively. The results explain that the majority of respondents agreed that it may cause an influence on management decisions, while 30% and 36% of them agreed and strongly agreed with this respectively. By contrast, 22% disagreed and only less than 3% of them strongly disagreed with this assertion. Along with that, only 8% of the respondents were uncertain. The respondents, regardless of their managerial experience and their bank assessed the *musharakah* profitability without difference, while the results show the differences between the respondents' groups according to their banks in their assessment to *musharakah* risk.

SIBs have a lower degree of control over the management of the enterprise they finance through *musharakah* contract. By contrast, credit risk related to financing through non-PLS modes are lessened by the possibility of collateralization, including mortgaging. The assessment of an appropriate level of the capital adequacy ratio for SIBs should be primarily based on systematic analysis of the

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underlining asset portfolio between PLS and non-PLS transactions. Although the PLS contracts perhaps present significant risks to SIBs, it also presents profitable opportunity. Hence, there is a need for risk analysis and risk management tools.

In regard to the performance of the risk compared with the profitability, it is generally clear that there is a harmony between the risk and profitability of *musharakah*: whenever one of them increases the other also increases and vice versa. This financial activity is consistent with the economics principle which states that there should be proportionality between profit and risk. Hence, the researcher might say that the profitability is quite high and the risk is to some extent also high. However, *musharakah* profitability is higher than its risk.

11.2.8 Profitability and Risk Financial Performance

The profitability analysis shows there is no difference between the methods as their significance is 0.385. Similarly the risk analysis shows that there is no significant difference between these methods in terms of risk rates, stating, as the F test shows the significance to be 0.547. The researcher can, therefore, conclude that there is no difference between the profitability and risk of these methods, namely *musharakah*, *murabahah*, *salam*, and other methods.

11.2.9 Factors Influencing Granting Credits

The analysis proves that all factors studied are of the same level of importance. These factors are risk, limited credit ceilings, profitability and personal qualities of the clients.

11.2.10 Factors Influencing the Distribution of Banks Funds

The results, significantly, indicate that respondents placed greatest importance on credit policies set by the Central Bank and greater importance on the amount of funds available and risk of finance methods. Factors such as profitability of finance methods, the activity type and other factors score relatively less. The majority of the respondents (75%) believe that the BOS credit policy is the first

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important factor and almost 10% of them only believe it is the second important factor. The amount of fund available is the second important factor giving that almost 37% of the respondents believe it is the second important factor while the percentages of them who chose it as the third, fourth or fifth important factor was less than 20% for each rank. In addition, the respondents believe that the risk of finance method is the third important factor affecting the decision of distributing funds available to different methods of finance at their budgets. As almost one third of the respondents consider risks of every finance method is the third important factor, whilst 27% of them believe it is the fourth important factor. The respondents also believe that the profitability of finance methods is the fourth important factor with 32%. Then the activity type comes in as the fifth important factor with 42%. Lastly other factors come as the sixth and least important factor.

11.2.11 Credit Policy

The Central Bank has the authority to change the return on partnership projects by altering the ratios in which the bank and the entrepreneurs are expected to share the capital and consequently the profits and losses that are associated with the transactions. To achieve its policy, the Central Bank has control over the supply of high-powered money, the reserve ratios on the different types of liabilities, and the maximum amount of assets, which the banks can allocate to their profit sharing activities. Overall for the period 1990-2005, we see a gradual increase in the minimum percentages of the capital sharing of the customers in *musharakah* projects. This may indicate an intention to discourage the use of *musharakah*. It may indicate also that *musharakah* is preferred by the entrepreneurs, for that reason and in order to control the money supply and demand, the Central Bank issued such policies. While specifying a percentage for the capital share for financing professionals, craft makers, and small producers including productive families started from 1999, the percentage in all sectors has been left to individual banks to decide.

The average minimum ceiling for the partner to invest within any *murabahah* project in priority sectors, cooperative sector for production purpose and cooperative sector for non-production purpose were 25%, 10% and 25%

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respectively. The minimum ceiling percentage for *murabahah* in internal trade is less compared with the capital share percentage in *musharakah* in internal trade as the average for the minimum ceiling for *murabahah* was 25% in 1990-1992 and was then left to the banks to decide thereafter. This indicates that the BOS is pushing banks to use *murabahah* in internal trade. Starting from 2001 the percentage in all sectors has been left to individual banks to decide. After 1995, BOS depended on profit margins to control *murabahah* more than the minimum ceiling. The range for *murabahah* profit margins in priority sectors was between 30% - 45% in the 1990s and 18% - 15% after 2000. After 2002 the percentage in all sectors has been left to individual banks to decide.

BOS financing policies were hindering the *musharakah* finance as well as SMEs finance throughout the last fifteen years. The tariff and fiscal policies of government were designed without taking into account the interests of encouraging *musharakah* finance and small enterprises. The State Bank of Sudan's regulations required higher percentages of entrepreneurs' share, (especially between 1991 and 2000) for these enterprises to qualify for *musharakah* financing. Therefore, these regulations should be discontinued. It is possible to conclude that there is a need to end BOS discriminatory regulations.

11.2.12 Size of Banks

Most of the Sudanese banks are extremely small and cannot remain serious players in the market, as it continues to expand and attract large international banks. Since smaller banks cannot diversify their assets portfolios as much as larger banks can do, they need a larger amount of capital relative to their assets to inspire confidence in their viability as well as their ability to maintain their core operations over the longer term. For this reason the BOS requires banks to either strengthen their capital or merge to ensure greater strength. Capital requirements also depend on the riskiness of the banks' portfolio of loans and investments. If the more risky PLS modes of *mudarabah* and *musharakah* constitute a greater part of banks' assets, the need for capital may be relatively larger to guarantee the full repayment of demand deposits and also the withdrawal of investment deposits. If, however, the less risky sales-based modes of *murabahah*, *salam*, and

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ijarah constitute a larger proportion, the need for capital may be relatively less. The probability of default also determines the quality of assets and therefore the size of capital, and until a consensus is reached on the imposition of a penalty on the defaulting party, banks may have to be required to hold more capital.

Hence, it is necessary to remove the disadvantage of the small size of Sudanese banks by encouraging and facilitating the merger of a number of such banks so that an optimum size is attained. In the absence of an optimum size, their average overhead costs are high and it is not possible for them to diversify their risks or be able to compete successfully with large conventional banks which have now started to open in the south of the Sudan.

11.2.13 Factors Causing Non-Performing *Musharakah* Finance

With a significant level of differences as shown by Friedman chi-square test, the descriptive results indicate that respondents placed highest importance on lack of proper feasibility studies (mean rank 1.96, 1260 points), since 51% of them opted for it, while 23% of them preferred 'lack of following up the projects'. Other factors like 'lack of customer's experience' received less weight with 8%, whilst the rest of the factors all together weighed less than 5% including 'lack of bank staff's experience'. The results also suggest that there is a correlation between the managerial experience and the reason behind the non-performing *musharakah*. Little effort, if any, is directed to collecting information about creditworthiness of the entrepreneurs. However, it may be emphasised that the researcher has only looked at one face of the problem. Sudan faces problems of enormous complexity and gravity. The need for a credit scores system and data base for the customers is urged at this stage.

11.2.14 Factors Causing the Weakness of Following up Projects

The results regarding this section suggest that 'absence of specialized departments for follow up' is the most important factor with significant points of 1099 and mean rank of 2.60. That 31.6% of the respondents ranked it first, which can be compared with 20%, 20% and 13% who ranked it second, third and

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fourth. Concerning the second important factor the respondents believe that the need for specialized and technical experience is the second important factor causing the weakness of follow up projects, with significant points of 1040 and mean rank of 2.82, since 24% of the respondents believe it is. In addition, the respondents believe that the high cost of the follow up operations and the non-cooperation from the customers or their refusal is the third and fourth important factor, with mean rank of 2.84 and 3.14 respectively, and with a percent of 20% and 17% of the respondents who voted for. In fifth place comes weak or absence of appropriate incentives for those following up projects and lastly come the other factors.

It has been evident that lack of knowledgeable bankers in selecting, evaluating and managing profitable projects is a significant factor. It seems likely that greater administrative resources would be required to operate a PLS system effectively than would be required for the effective operation of a traditional system, though it is to be hoped that the resulting higher costs could be offset, or more than offset, by improved allocation of investment. Greater involvement by institutional providers of funds in determining the uses to which such funds are put should have a positive effect.

Following up entails additional cost for the banks arising from the cost of monitoring of the joint venture. Moreover, the banks incur the training cost. They have to train their staff in the fields of planning and execution of the projects. Furthermore, following up is unsuitable for the businesses involving petty and repetitive transactions. It becomes too difficult to maintain the records of such businesses or even to properly monitor them. In spite of the above-mentioned weaknesses, following up is based on sound theoretical foundations. It can operate efficiently in a large number of enterprises belonging to various sectors of the economy.

Notably none of the Sudanese banks has specialized banks for following up projects. It is recommended to establish a section under the investment department or risk management department to be devoted for following up only.

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More efficient supervision is needed because problems tend to be detected at an earlier stage especially offsite supervision. The supervisor can intervene or exert pressure before the situation deteriorates. More specialised supervision is also needed. Larger banks are supervised by more staff than smaller ones because they are systemic and more complex. Tailoring of regulations and requirements is also needed with the possibility of imposing tougher ones if needed.

11.2.15 Factors Determining the Capability of the Entrepreneurs

It is notable that customer's financial capability is the most important factor determining the capability of the entrepreneurs with significant points of 1230 and a mean rank of 2.08. 39% of the respondents ranked it first which can be compared with 27% and 22% who rank it second and third respectively. Concerning the second important factor, the respondents believe that the customer's experience is the second important factor with significant points of 1132 and a mean rank of 2.47. In addition, the respondents believe that the customer's financial history is the third important factor determining the entrepreneur's capability of being offered *musharakah* finance with significant points of 1112 and a mean rank of 2.55. The type of guarantee came fourth followed by references taken about the customer.

These results raise a fundamental question of whether intangible assets such as education, experience, and skills can be regarded as equal collateral as less than tangible assets in reality. Would it be possible to consider the intangible assets? Can Islamic Banks balance the priority to the needs of society and the common interest with individual profit and private interest?

Another obstacle in the use of *musharakah* is related to the way banks are looking at profit gain. Since profit is the main criterion to look into, banks will be tempted to finance high return projects, ignoring the socially beneficial projects. Hence, SIBs lack a social orientation, which seems to be necessary in all developing countries. The social benefits of ISBs cannot be fully utilized without the substantial use of the PLS mode of finance. Most of the limitations and

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obstacles outlined previously are products of weak experience of ISBs in applying PLS.

Group responsibility for repayment, which reduces default while such a grouping raises the size of finance and thus reduces administrative cost, were recommended. Fortunately this idealistic picture of co-operative societies has proved to be workable only in small and micro finance.

11.2.16 Satisfaction with Performance Measurement Systems

The results presented in the previous chapters demonstrate that 43% of respondents are to some extent satisfied with their bank's methodology for measuring the credit worthiness of entrepreneurs and project related risk, which seems likely to be the main risk facing *musharakah*, and 24% on the other hand are not satisfied. This may lead to strong advice to review their bank's methodology for measuring the credit worthiness of customers and project related risks.

With a significant chi-square, 46% of the respondents are satisfied with their banks' measurement systems for the performance of *musharakah* projects; whilst 38% of them are to some extent satisfied and only about 15% of them are not satisfied. As a result of this, it may be possible to conclude that a relatively simple majority of the respondents believe that the measurements of *musharakah* performance are quite satisfying and therefore there is no need to proceed further for substantial changes or improvement.

11.2.17 Managerial Efficiency and Quality Training Provided

With a significant difference as indicated by the chi-square, 41% of the respondents assume that quality related training is provided for all employees, whilst less than 25% of them do not believe so while the majority of them (43%) consider that all employees have been provided with quality related training. It is worthwhile to restate that most of the respondents (86%) have attended investment training courses. The results of the cross tabulation chi-square tests

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indicate that the quality related training programme is not provided with the same degree in all sampled banks. Some of these banks do provide some training programmes of better quality compared to the rest.

Efficient supervision over banking operations could have greatly reduced the problems, but efficient supervision requires the availability of trained bank examiners, controllers and supervisors, well-versed in the applications and operations of the new procedures and techniques, and thoroughly familiar with the theoretical and practical details of interest-free banking operations. Such expertise on a sufficient scale has been lacking and it may take many years for an efficient system of supervision to be satisfactorily installed.

To conclude, appropriate training programmes need to be designed and adopted to upgrade the skills of staff. Short training programmes for the target group need to be considered.

11.2.18 Other Obstacles Hindering *Musharakah* Projects

With a significant level of differences indicated by the Friedman test, the results confirm that the most influencing obstacle is lack of feasibility studies with 1265 points and mean rank of 1.94. In addition, 38% of the respondents ranked it first and 36% ranked it second. The lack of well experienced customers, with 1204 points and mean rank of 2.18, came as the second important obstacle followed by limited credit ceilings which has 1096 points and 2.62 as mean rank. The thesis presented here is that it is impossible to judge the riskiness of *musharakah* transactions in a bank's portfolio without considering how the returns on these transactions compare with the rest of the bank's returns, and that the effect on risk of adding a *musharakah* transaction to a bank's portfolio is based on the comparison between returns on *musharakah* transactions and its overall portfolio returns. This should be in mind when looking at any proposal and feasibility study for *musharakah* finance.

11.3 Recommendations of the Study

The analysis presented in this study, provides an ample opportunity to reflect on the results to develop some recommendations to overcome the highlighted shortcomings, obstacles and difficulties.

11.3.1 Recommendations Concerning Legal Regulations and *Musharakah* Contract

- (i) The legal framework should be in line with the Islamic *Shari'ah* and lawyers, magistrates, judges in the court should be fully familiar with the Islamic banking and economic system;
- (ii) It is argued that, by making the bank a partner in the business of the entrepreneur, it may disclose the secrets of the business to other traders through the bank. This obstacle in many cases is almost theoretical as the banks usually do not interfere deeply with the management affairs which cause another problem to *musharakah* projects. However, a suggestion can be made to include a condition in the contract which prohibits the bank either from interference with the management affairs or disclosure of any information about the business to any person without prior permission of the entrepreneur (Usmani, 1999);
- (iii) The Government of Sudan should enact a specific law to regulate the conduct of *musharakah* financing. This law should obligate the clients to keep complete accounts of the *musharakah* financed projects. Banks should have the right to probe the accounts and monitor the project at different stages. Moreover, specific regulations should be enacted to close all possible loopholes for cheating, fraud and concealment; and
- (iv) To improve the contract conditions. This can minimize risk and give more authority to following up these projects.

11.3.2 Recommendations Concerning Entrepreneurs

- (i) Entrepreneurs and business enterprises obtaining capital from banks and other financial institutions should maintain proper accounts and this should be done honestly so as to reveal the true working results of the enterprises;
- (ii) Entrepreneurs must provide documents certifying each stage of their projects' progress, before the capital is provided for that particular stage; and
- (iii) Entrepreneurs should be educated about the concept of Islamic finance in general, and *musharakah* financing in particular

11.3.3 Recommendations Concerning SMEs and Microfinance

- (i) There is a need for a co-ordinating mechanism between the banks themselves and other institutions concerned with small enterprise financing;
- (ii) There is a need for national policies specially designed and oriented towards Small and Medium Enterprises (SMEs);
- (iii) Banks should establish branches in the residential areas. This new banking convention can reformulate the bank-client relationship on both the savings and investment sides with regard to regulatory control;
- (iv) A serious effort is needed on socio-cultural, moral, and political fronts to develop a culture of sound and fair SMEs business finance and practices. Media and mosque institutions and political parties can play an important role in developing this culture; and
- (v) Training programmes targeted at rural people must implement training on issues of financial management such as regular recording of daily expenses and revenues, calculation of profit and losses, and keeping track of the dates and amounts of loans and repayment date. For the small entrepreneurs, emphasis should be on book-keeping, record-keeping and marketing, group management leadership training

and community mobilisation and initial business appraisal and advice for all finance applications. Entrepreneurs need to properly diagnose the causes of non performing investment (formerly non performing debts) so as to learn and not repeat the same mistakes.

11.3.4 Recommendations Concerning the Central Bank

- (i) It is necessary to institute a dialogue between the Central Bank and Islamic banks to design separate and different rules and regulations for supervising *musharakah* so as to facilitate and encourage banks to use this mode of finance. It is important, therefore, to study the credit policy to see how it effects the decision of distribution of the available funds among various modes of finance.
- (ii) Ending the BOS financing policies hindering *musharakah* and BOS discriminatory regulations so as to encourage PLS finance.
- (iii) Setting polices which require banks to either strengthen their capital or merge to ensure greater strength. It is necessary to remove the disadvantage of the small size of Sudanese banks by encouraging and facilitating the merger of a number of such banks so that an optimum size is attained. In the absence of an optimum size, their average overhead costs are high and it is not possible for them to diversify their risks or be able to compete successfully with large conventional banks which have now started to open in the south of the Sudan. In this sense it is important to continue the BOS current reforms of the banking system which aim to unify bank accounting systems as well as regulations on capital adequacy ratios according to Basle standards, monitor non-performing loans monthly, restructure and privatize public banks; merge, liquidize; or recapitalize small banks; reduce non-performing loans; and improve loan evaluation.
- (iv) Setting policies to instruct banks to provide finance to the poor and small entrepreneurs who currently have little access to finance with the objective of expanding the social capital and economic capacity of the society

11.3.5 Recommendations Concerning Banks

11.3.5.1 General Recommendations

It is worth mentioning that banks have to work efficiently, so as to achieve the best results for the investment projects, to improve customers' skills in management by conducting training to customers in small business management marketing policies and promotion; and quality and production control.

Facing all the economic and political barriers fronting the country e.g. high inflation rate as external factors, as well as internal factors e.g. small size of the capital and lack of managerial efficiency, the Sudanese Islamic bank have to involve in long term finance. It should be stated that one of the major dilemmas facing the present Sudanese Islamic banks is the fact that these banks have to be involved in long-term finance. The financing of long-term projects has certain prerequisites. The Islamic bank will have to identify projects, carry out feasibility studies, estimate expected streams of profits and only then shall they be able to invest in a project. Moreover, they will have to develop a long-term investment strategy (Al-Harran, 1993). SIBs have a moral obligation, which makes their role unique and superior to traditional banks, to fulfil in order to alleviate some of the problems that face the nation today. There is a need for a shift in the Sudanese banks operations into long-term entrepreneurship finance. Hence, fiscal policy, credit policy as well as individual banks policy should encourage and support this shift.

A consultancy or an advisory service may be introduced at the branches (perhaps through technical assistance) to help clients in identifying business opportunities, drawing business plans, preparing financial proposals, etc. Many donors would welcome a request for such assistance. In addition, individual counselling can be introduced or one-to-one discussion which has many advantages as a means of adult training and education. It clearly addresses the unique needs and situation of the individual involved and enables the advisor or counsellor to take these unique circumstances into account when giving advice or information. The exchange of ideas that is possible in one-to-one discussions is very beneficial in

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helping people reassess situations and change their attitudes to problems and solutions. When dealing with money issues, these are intensely personal and few like to discuss their affairs in detail unless they are with someone they trust. Developing this kind of trust is possible with individual counselling. It is obviously possible to teach practical financial management skills like book-keeping in a one-to-one situation but it is costly in terms of time.

11.3.5.2 Risk Management Related Recommendations

The following can be advised to improve the banks risk management

Sudanese Islamic banks should encourage the use of *musharakah* in agriculture finance. The following should be adopted to minimise *musharakah* finance for agriculture:

- (i) Delivery of farm financing in instalments according to the actual needs of the crops' growth stage accompanied with frequent visits to the projects receiving financing;
- (ii) Contributing to the establishment of the national insurance company to encourage the establishment of insurance services for farming activities;
- (iii) Participating in the establishment of crop marketing companies to help in marketing crops produced by the project subject of finance such as Sudan Cotton;
- (iv) More financial training for the staff, especially with regard to proper delivery and collection procedures.
- (v) Diversification strategy is advised to minimise the risks through financing different entrepreneurs instead of concentration of finance to a few of them, as well as diversification in financing different sectors in different seasons
- (vi) Specialization is also advised. The bank may accumulate intimate knowledge of some markets in which they have concentrated. This may enable the banks to protect themselves more efficiently against

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too optimistic entrepreneurial calculations in these areas, although a perfect protection seems to be impossible.

- (vii) Improving the contract conditions which can minimize risk and give more authority to following up these projects.
- (viii) Part of the profits could be used to build up reserves as a buffer against possible future losses.

More efficient and specialized supervision for investments is needed because problems tend to be detected at an earlier stage. The supervisor can intervene or exert pressure before the situation deteriorates. Larger banks supervised are by more staff than smaller ones because they are systemic and more complex. Tailoring of regulations and requirements is also needed with the possibility of imposing tougher ones if needed. The internal supervision needs more attention. The bank staff should watch its interest by focusing on the overall performance of the project. More on-site inspections/audits should be carried out to check in-depth an entrepreneur's financial position and current financial condition; the entrepreneur's risk management and procedures and adequate collateral coverage. The following can be recommended to improve following up projects:

- (i) The Sudanese banks need to build stronger internal control mechanisms, as some of their problems are caused by internal factors;
- (ii) A third party to follow up and share certain percentage in the total profit is also recommended. It is recommended to manage and monitor a specific number of *musharakah* transactions through a hired part-time manager whose cost is covered from the share of profit earmarked for management. After liquidation the same manager could monitor another set of *musharakah*. The bank could create employment opportunities for unemployed graduates whose numbers increase annually as a result of expansion in higher education;
- (iii) Appropriate training programmes need to be designed and adopted to upgrade the skills of staff. Short training programmes for the target group need to be considered;
- (iv) The spread of bank branches must be well planned.

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- (ix) Banks might accept to finance high risk *musharakah* on a selective basis to a number of entrepreneurs, for whom, these banks come to know have integrity beyond all doubts. In addition some selected sectors might be visible for *musharakah* finance where there is not much space for misconduct, negligence and dishonesty to work as an obstacle for financing through *musharakah* such as export and import. For instance, almost every essential thing will be known e.g. the exporter will have the specific order from abroad, the prices are agreed, the costs are not difficult to determine, payments are normally secured by a letter of credit, the payments are made through the bank itself. Similarly, financing of imports may be designed on the basis of *musharakah* with some precautions, as explained earlier. (Usmani, 2002).
- (x) Each of the well-trained bank staff could handle a specified number of transactions annually. Hence, specification would contribute to efficiency of the bank and would expedite the completion of transactions.
- (xi) Banks need to manage the credit risk inherent in the entire portfolio as well as the risk in individual credits or transactions;
- (xii) Banks should also consider the relationship between credit risk and other risks, sound credit risk management practices should be applied in conjunction with sound practices related to the assessment of asset quality, the adequacy of provisions and reserves, and the disclosure of credit risk.
- (xiii) Credit scores should be applied to measure entrepreneurs' risks. It is worth mentioning the urgent need for the data system about entrepreneurs' history and works. Since if any misconduct, dishonesty or negligence is established against a client in any bank, he might be subject to punitive steps, and may be deprived of availing any facility from any bank in the whole country, at least for a specified period. However such an approach is yet to be implemented in Sudan;
- (xiv) A fair and proper measurement should be taken to estimate the management role on the profit and this should be reflected on the management share of profit denoted to the entrepreneur.

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A specialized department for risk management and follow up should be established. The roles expected to be played by the suggested specialized and technical department are:

- (i) Information systems and analytical techniques to measure the credit risk inherent in all activities;
- (ii) Setting the bank annual credit policy;
- (iii) Have in place a system for monitoring the overall composition and quality of the credit portfolio;
- (iv) Take into consideration potential future changes in economic conditions when assessing individual credits and credit portfolios;
- (v) Established system of independent, ongoing credit review to evaluate the condition of the credit portfolio and performance of credit officers;
- (vi) Ensure credit granting function is properly managed and credit exposures are within internal limits; and
- (vii) Credit risk strategy to include a statement of the bank's willingness to grant credit based on type (commercial, consumer, real estate, etc.), economic sector, geographical location, currency, maturity, and anticipated profitability;
- (viii) Credit risk strategy to include a statement of the bank's willingness to grant credit based on mode of finance type (*musharakah*, *murabahah*, *salam*, etc.);
- (ix) The credit limits on single entrepreneurs and groups of connected entrepreneurs;
- (x) Identification of target markets and overall characteristics the bank wants to achieve in the credit portfolio.

11.3.5.3 Data Improvement

The quality of the Sudanese banking industry data has improved in recent years. However, there are many areas where further improvements are needed, particularly in compiling accounts and modes of finance accounts of the branches. Also there is a need for initiating financial reporting according to the

mode of finance and publish details of the non performing debts and investment for these methods together with its profit. Standardization of the data for all banks is also important in order to analyse the realities of Islamic banking.

11.3.5.4 Measuring Creditworthiness

The results raise a fundamental question of whether intangible assets such as education, experience, and skills can be as equal collateral as less than tangible assets in reality. Would it be possible to consider the intangible assets? Can Sudanese banks balance the priority to the needs of society and the common interest with the individual profit and private interest?

Another obstacle in the use of PLS is related to the way banks are looking at profit gain. Since profit is the main criterion to look into, banks will be tempted to finance high return projects, ignoring the socially beneficial projects. Hence Islamic banks lack a social orientation, which seems to be necessary in all developing countries. The social benefits of ISBs cannot be fully utilized without the substantial use of the PLS mode of finance. Most of the limitations and obstacles outlined previously are products of weak experience of ISBs in applying PLS. Alternatively, the combination of both the trustworthiness of the entrepreneur and the viability and usefulness of the project (i.e. towards the physical expansion of production and services) may encourage large and small entrepreneurs to venture into business with greater possibility of getting financing from Islamic banking. In addition the following should be considered:

- (i) Group responsibility for repayment should be introduced in small and microfinance;
- (ii) Banks should ensure that their methodology for measuring the credit worthiness of entrepreneurs and project related risks is of a high standard;
- (iii) The bank's credit-granting activities should conform to the established criteria;

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Alternatively, the combination of both the trustworthiness of the entrepreneur and the viability and usefulness of the project (i.e. towards the physical expansion of production and services) may encourage large and small entrepreneurs to venture into business with a greater possibility of getting financing from the Islamic banking systems.

11.3.6 General Recommendations

- (i) To internationalise *musharakah* financing as the main front of Islamic finance in order to bring about real changes in the economies of the developing countries where Islamic banks operate;
- (ii) To establish an international body to set standards for *musharakah* financing to Islamic banks; establishment of a training institution where “implementers” of Islamic financial products could be trained;
- (iii) Exchange of visits among Islamic bank staff;
- (iv) Standardisation of *musharakah* procedures;
- (v) To establish and strengthen the capability of the market research and consultancy centre to make business advice more widely available in Sudanese and to integrate general business consulting activities with more technical services;
- (vi) To establish a restructured *musharakah* PLS Promotion Agency to strengthen its capacity and the performance of *musharakah* PLS in investment promotion.

11.4 Areas for Further Research

There are many issues not covered by this study which might be suggested for further research.

- (i) The further growth and development of the Islamic financial system will depend largely on the nature of innovations introduced in the market. The immediate need is to deploy human and financial resources to develop instruments to enhance microfinance, perform asset/liability and risk management; and introduce long term

entrepreneurship finance instruments. Hence, managerial efficiency is an important topic for further research;

- (ii) Further research is required to provide more insight into the topic of internationalising *musharakah* financing as the main front of Islamic finance in order to bring about real changes in the economies of the developing countries where Islamic banks operate;
- (iii) Another area that would be of research interest is a comparison study of *murabahah* and *musharakah* efficiency and performance in Sudan;
- (iv) There is a further need for more empirical studies, particularly to evaluate the effectiveness of monetary policy and the tools of monetary management against the objectives and goals which have been set for them;
- (v) The area of male gender domination in both employment and entrepreneurship in Sudan needs further study;
- (vi) Further research is also required in the area of Islamic microfinance especially of using profit and loss modes;
- (vii) The relationship between entrepreneurs and Islamic banks is of some importance and recommended for further research;
- (viii) The perception of *musharakah* users should also be examined to identify the performance of their enterprises, and determine the obstacles and prospects they face in order to complete the picture about both parties of the participatory finance.
- (ix) Similar studies can be undertaken to identify the performance of *musharakah* financing in other countries with the objective of having a comparison, and determining the performance differences and the reasons of such differences.
- (x) Can this system be exported to other countries, or does it depend too much on the charisma of the Sudanese bank and the special characteristics of the Sudanese entrepreneur to be transplanted successfully? These issues need more indepth study. Hence it is also recommended; and
- (xi) Lastly, risk management systems for Islamic banks in general are crucial. Given the nascent nature of the Islamic financial industry

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there is a need to develop *shari'ah* compatible risk management techniques and organize training programmes to disseminate these among the Islamic banks. Therefore, risk management needs to be assigned as a priority area of research and training programmes.

Appendixes

A. The Questionnaire in English

Confidential questionnaire for the Investment Department Employees’ in The Banking Industry in Sudan

The following questions relate to your bank using *musharakah*. I recognize that some of the information in this survey may be sensitive, but I assure you that the data will only be used in the aggregate to statistically compare various types of banks that have participated in the study. Your responses will be kept confidential.

Please answer the questions below by circling, ticking the correct replies or by filling in information.

Section one: Personal Profile

(Please tick the appropriate answer for each of the following questions)

Q1. Sex:

☐ Male. ☐ Female.

Q2. What is your age (years)?

☐ 20-30. ☐ 31-40. ☐ 41-50. ☐ Above 50.

Q3. Marital Status:

☐ Single. ☐ Married. ☐ Other.

Q4. What is the highest educational qualification you hold?

☐ Sudan Senior School Certificate ☐ Diploma
☐ Bachelor ☐ Postgraduate ☐ Other, please specify-----

Q5. How many total years of managerial experience do you have?

☐ 1- 5 ☐ 6- 10 ☐ 11 – 15 ☐ 16 – 20 ☐ Over 20 years

Q6. How many total years of investment management experience do you have?

☐ Less than 3 ☐ 3 – 5 ☐ 6 – 8 ☐ 9 and above

Section two: Bank Information (Please tick the relevant boxes)

Q7. The name of the bank and the branch you are working for

Q8. How many people work under your direct supervision?

Q9. What is your Job level in the bank’s hierarchy?

Q10 Did you take any Investment course or training?

☐ Yes. ☐ No.

Q11. Are you satisfied with your current salary?

☐ Yes. ☐ No. ☐ To some Extent

Section three: *Musharakah* Method Preference

(Please tick the relevant boxes)

Q12. Do you choose the method of finance for the customer?

☐ Yes ☐ No (go to Q14)

Q13. If yes, what is the factor/s which effects your decision when you choose to fund a customer using *musharakah* method? Please rank in order starting with the most important:

☐ Customer credit worthiness ☐ Expected risk.
☐ The customer's choice of financing method. ☐ Expected profitability.
☐ The activity type whether it is agricultural or industrial etc....
☐ Credit policies set by the Central Bank.

Q14. Do you stipulate at the beginning of the year how much you are going to fund by each method in your budget?

☐ Yes. ☐ No (go to Q17)

Q15. If yes, which of these factors affects distribution of funds for each Islamic finance method in your budgets? Please rank in order starting with the most important:

☐ Credit policies set by the Central Bank. ☐ Profitability.
☐ The amount of fund available. ☐ Risk.
☐ The activity type. ☐ Other, please specify...

Q16. The lack of risk management knowledge of the Sudanese Bank managers is behind the weakness of the budgets set for Islamic finance methods. Do you agree? (Please tick one box only).

☐ Strongly agree. ☐ Agree. ☐ Uncertain ☐ Disagree. ☐ Strongly disagree.

Q17. If no, what is the reason behind that? Please rank in order starting with the most important:

☐ Not Useful or no need for it ☐ Usually external factors are stopping it
☐ The senior managers don't think it is important
☐ Other, please specify.....

Q18. The following factor/s determines the capability of the customer to be offered finance using the *Musharakah* method. Please rank in order starting with the most important:

☐ Customer's financial capability and current account movement
☐ Customer's financial history ☐ Reference received about the customer
☐ Customer's experience ☐ Type of Guarantee provided by the customer

Section four: *Musharakah* performance and management.

Q19. According to your experience, rank the performance of *musharakah* according to the profitability and risk majors?

A. Profitability

☐ Very High ☐ High ☐ Acceptable ☐ Low or none ☐ Not sure

B. Risk

☐ Very High ☐ High ☐ Acceptable ☐ Low or none ☐ Not sure

Q20. In your personal opinion which one of the objectives below is more important for the Islamic bank to achieve first during its operations (*musharakah*)? Please rank in order starting with the most important:

☐ Maximizing the return of the shareholders and depositors.

☐ Customer satisfaction.

☐ Contributing to the economic and social development of the country.

☐ Other, please specify.....

Q21. What is the average age of the *musharakah* projects?

☐ Less than 3 months. ☐ 3- 6 months. ☐ 7- 12 months.

☐ 1-2 years. ☐ Above 2 years.

Q22. Rank the following sectors starting with the one which should have the biggest amount of *musharakah* fund?

☐ Commercial (Trade). ☐ Industrial. ☐ Agricultural.

☐ Export and import. ☐ Co operative, small producers and craftsmen.

Q23. The bank usually prefers trade finance. If you agree with this statement, which of the following is the reason for you to prefer trade finance? Please rank in order starting with the most important.

☐ High profit margins. ☐ The low risk.

☐ The rapid turn over of the capital in trade.

☐ Inadequate capital for other non trading investments.

Q24. Please indicate whether you agree or disagree with the following statements:

A. The right to interfere in the management decisions as a partner (the bank) results in *musharakah* not being attractive for the customer

☐ Strongly agree. ☐ Agree. ☐ Uncertain ☐ Disagree. ☐ Strongly disagree.

B. The bank practice great institutional influence on the management decisions in partnership projects because *musharakah* contracts are exposed to high risk

☐ Strongly agree. ☐ Agree. ☐ Uncertain ☐ Disagree. ☐ Strongly disagree.

Q25. Indicate the relative importance of the following factors in influencing, granting credits, hindering investment in any project and fund allocations. Please rank in order starting with the most important.

- ☐ Risk ☐ Limited credit ceilings ☐ Profitability
☐ Personal qualities of the clients

Q26. Please indicate whether these statements are correct or not according to your opinion:

	Yes	No	To some extent
a- You are aware of the accurate product cost of the partnership projects			
b- You share the pricing decision with your partner			
c- Your Bank is committed to a quality improvement programme for the partnership finance			
d- Management actively supports your quality programme			
e- Quality-related training is provided for all employees			
f- You are satisfied with your bank performance measurement systems for <i>Musharakah</i> projects			
g- You are satisfied with your bank methodology for measuring the credit worthiness of the customer and the project related risk			

Q27. Are there is any regulations from your bank encouraging using PLS methods of finance?

- ☐ Yes. ☐ No.

Q28. What type of transaction do you prefer to have with your customer?

- ☐ *Musharakah* ☐ *Murabahah* ☐ *Salam* ☐ Other, please specify.....

Section five: Obstacles and Constraints

Q29. Are there any obstacles from your point of view which particularly hinder *Musharakah* projects? Please rank in order starting with the most important.

- ☐ Lack of funds. ☐ Lack of managerial efficiency.
☐ Lack of feasibility studies. ☐ Lack of well experienced customers.
☐ Other, please specify.....

Q30. What is the factor/s which causes the weakness of following up projects by the bank? Please rank in order starting with the most important.

- ☐ High cost of the following up operations
☐ Non-Cooperation from the customers or their refusal
☐ Absence of specialized departments for following up
☐ Weak or absence of good incentives for those following up projects
☐ The need for specialized and technical experience in some *Musharakah* projects
☐ Other, please specify.....

Q31. What is the factor/s which causes the non-performing *musharakah* (non performing debts) Please rank in order starting with the most important.

- ☐ Lack of proper feasibility studies
- ☐ Lack of following up the projects
- ☐ Lack of customer's experience
- ☐ Lack of bank staff's experience
- ☐ Lack of proper risk management
- ☐ Other, please specify...

Q32. What kind of work should the bank as a partner be responsible for? Please rank in order starting with the most important.

- ☐ Administrative (solving day to day operations).
- ☐ Marketing.
- ☐ Providing money only.
- ☐ Providing raw material, machinery or equipment.
- ☐ Other, please specify.....

Q33. If you have any further comments, please add them here:
Other comments: -----

Thank you for your co-operation.

The identity of respondents will be treated in strict confidence and not revealed in the thesis or any other publications. If you want your copy of my findings, please provide me with your details and address:

Name.....

Address.....

Telephone.....

Fax.....

E-mail.....

B. Musharakah Contract for Working Capital

Core Clauses:

1. The Parties:

A. An Islamic Bank, as a first partner, and

B. A legal or natural person, as a second partner
2. Statement of objective of *Musharakah*, such as “The Second Partner approached the bank to enter into a partnership agreement to operate the factory of located at which is owned by the second partner, for a period of
3. A *Musharakah* is hereby established between the two partners as follows:

A. The first partner provides a capital of SD for the purpose of using it as an operational capital for the factory

B. The second partner provides the net worth of his factory as represented in the balance sheet, as amended and accepted by the two partners; in the amount of

4. The second partner shall manage this *Musharakah* in the usual and customary manner and to the best interest of the partnership within the scope of a mutually agreed upon policy and strategy. However, the first partner shall appoint one of its employees, as a representative in the partnership. The representative has the full right to inspect accounts, books and records of the partnership at any time, and to place a reservation or an objection on any managerial acts he sees unfit with the best interest of the partnership.
5. All banking transactions of the partnership shall be exclusively effected in...., with and through the first partner.
6. The second partner pledges to supply the bank with quarterly reports and to consult with its representative before taking any decision in important matters and to take a written approval before disbursement, or pledge of disbursement of any amount exceeding SD
7. The distribution of profits shall be as follows:
 - A.% to the second partner as compensation for his managerial efforts
 - B. The remainder shall be distributed according to the shares in capital, as mentioned in Article 3 of this agreement and any losses shall solely be distributed in proportion to share in capital as in Article 3 too.
8. The duration of this *Musharakah* is(months or year), i.e., until the day..... of the month of of the year only; and a balance sheet shall be prepared at the end of this period and sufficient assets of the partnership shall, by then, be liquidated to pay the share of the first partner plus/minus profit or loss.
9. The second partner puts under the full authority of the first partner his..... (Securities, real estates, etc.) as a guarantee to be used only in case of any damage caused by neglect or transgression by the second partner.

Other Clauses:

1. Number of original copies of the contract.
2. Determining the Court of competent jurisdiction over the contract.

C. Declining *Musharakah* Contract that Applies to Fixed Assets

Core Clauses:

1. The Parties:
 - A. An Islamic Bank, as a first partner, and
 - B. A legal or natural person, as a second partner

2. The objective of partnership is to construct (purchase) a..... (Airplane, ship or building in the specification mentioned in Annex I and operate it for profit.
3. A *Musharakah* is hereby established between the two partners as follows:
 - 1) The first partner provides 90% of the capital or SD.....
 - 2) The second partner provides 10% of the capital or SD.....
 - 3) In case the cost of the assets to be constructed (or purchased) exceed the amount of SD..... the increment shall be contributed by the parties in the same proportion.
4. The second partner shall manage this *Musharakah* in the usual and customary manner and to the best interest of the partnership within the scope of a mutually agreed upon policy and strategy. However, the first partner shall appoint one of its employees, as a representative in the partnership. The representative has the full right to inspect accounts, books and records of the partnership at any time, and to place a reservation or an objection on any managerial acts he sees unfit with the best interest of the partnership.
5. All banking transactions of the partnership shall be exclusively effected in, with and through the first partner.
6. The second partner pledges to supply the bank with quarterly reports and to consult with its representative before taking any decision in important matters and to take a written approval before disbursement, or pledge of disbursement of any amount exceeding SD.....
7. The distribution of profits shall be as follows:
 - A.% to the second partner as compensation for his managerial efforts
 - B. The remainder shall be distributed according to the share in capital mentioned in Article 3 of this agreement and any losses shall be distributed in proportion to share in capital as in Article 3 too.
8. The duration of this *Musharakah* is nine years.
9. The first partner promises to sell out his share, ..% of the total capital of the partnership to the second partner at the end of each accounting year for the amount of SD ..., payable at the time of signing the sale contract.

Other Clauses:

1. Number of original copies of the contract.
2. Determining the Court of competent jurisdiction over the contract.

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